FRANCHISING IN THE U.S. ECONOMY

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HOUSE OF REPRESENTATIVES

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FRANCHISING IN THE U.S. ECONOMY

THURSDAY, SEPTEMBER 27, 1990

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman **LaFalce**. The Small Business Committee will come to order. Franchising has swept across the American marketplace in the past decade changing the way Americans conduct business and purchase goods and services. It has been called the most dynamic business arrangement since the corporation and a dominating force in the U.S. economy.

Where once franchising was limited to automobile and gasoline dealers, hotels, and fast food outlets, it has emerged in such diverse areas as financial services, electronics, health care, corporate services, and even educational institutions.

So pervasive has its influence been throughout the economy that it has become increasingly difficult to purchase a product or service that is not affected by franchising in some manner.

Franchising's success derives not only from its adaptability to an expanding array of industries and markets, but also from the unique ability of franchise arrangements, when properly structured and implemented, to accommodate the diverse economic needs of key segments of the economy.

For large companies and new businesses, franchising offers a systematic and cost-effective method for rapidly expanding marketing and distribution networks with a minimum of direct involvement and financial investment.

For aspiring entrepreneurs, it provides an opportunity to own and operate a business involving a tested product or format with a minimum of financial risk. For consumers, franchising provides a way to purchase known products and services in a consistent and reliable manner.

Franchising now accounts for a large segment of the Nation's small businesses and plays a major role in new small business formation. The 27,000 new franchise outlets estimated to have been opened during 1988 represent the addition of a new small business every 20 minutes of every day throughout the year.

Some 3,000 U.S. companies currently operate franchise networks encompassing more than ½-million franchises across the Nation. These franchises collectively employ more than 7 million American workers and account for more than $600 million in annual retail sales—roughly one-third of all retail sales of goods and services in our economy.

The same factors that have prompted franchising's success in this country are also at work around the world. In January we saw the opening of a McDonald's restaurant in Moscow; last week a Pizza Hut opened its doors in Beijing.

These are the most visible examples of an increasing internationalization of franchising that is making American franchise trademarks, products, and business operations familiar objects throughout the world. Foreign franchisors are also entering the U.S. markets in increasing numbers, opening or acquiring sizable franchise networks.

At a time when business journals and magazines are heralding the growing successes of franchising at home and abroad, I am troubled by the increasing number of reports that document serious and continuing problems. Recent press reports have reported, for example, growing numbers of fraudulent franchise arrangements; increasing incidence of franchise terminations related to corporate mergers and take-overs and to foreign acquisitions of franchising systems; rising numbers of law suits and class action suits by franchisees against franchise companies; and significant increases in arbitration proceedings to resolve disputes between franchisors and franchisees.

These reports suggest that there are significant problems in franchising that will only become more pronounced if the economy continues to weaken. These reports also raise serious questions as to the adequacy of current law and regulation for assuring proper structuring and operation of franchise systems and for protecting the interests and expectations of consumers.

Let me add that I am also disturbed by some apparent contradictions and inconsistencies that seem to pervade our entire discussion of franchising.

For example, we currently have no Federal law which broadly governs franchise sales or operations, and yet the Federal Trade Commission spent much of last year debating whether it should preempt all or part of the States' franchise laws.

The Federal Government requires comprehensive disclosure of all aspects of a franchise opportunity to protect potential investors, and yet no office or agency of the Government even collects, let alone reviews, these disclosure documents.

State regulators continue to advocate for stronger and more comprehensive State enforcement of franchising practices, but yet only a third of the States have bothered to provide for any form of broad franchise regulation.

Franchisors argue that market forces will remedy serious inequities within franchise systems, but yet they impose contracts that are so restrictive that they effectively eliminate all elements of the market in the operation of their franchise systems.

These and other contradictions in franchising are troubling and suggest the need for a broad national discussion of the purposes, potential, and problems of franchising, of the role franchising can and should play in the Nation's economy, and perhaps the role that franchising can and should play in the international economy. Unfortunately, such discussion has been hampered by a lack of comprehensive and accurate information about franchising nationally.

Many of the figures I have cited are sophisticated guesstimates of national franchise growth and sales. There is currently no Federal agency that collects even basic information about new franchise development and franchise sales.

We have virtually no basis for developing comprehensive national data on such things as franchise fraud, franchise failures and terminations, and franchise litigation. Such data is very important if we are to undertake any kind of responsible discussion of appropriate policy and regulation in this area.

The purpose of today's hearing is to begin a process of broad inquiry and discussion into franchising, and to document its growing significance in our Nation's economy. At the same time, we want to begin to assess, in general terms, the adequacy of current laws and regulation governing the structuring, sale and operation of franchise arrangements.

Two questions are important in this regard. Are current laws and procedures adequate to protect the interests of franchisors, franchisees, and consumers? Are additional, or alternative structures or policies needed at either the State, national, or international level?

Let me add that I am increasingly interested in the international aspects of this question in addition to the national. As someone who has spent years promoting international trade and improvement in the competitive position of American business, I look to the movement of American franchisors abroad, especially in those countries that have had centrally planned economies and are now emerging to a market-oriented economy, with both enthusiasm and concern.

I sense that there are numerous obstacles to the expansion of franchises abroad which have yet to be addressed in any fashion in either our Nation's bilateral or multilateral trade negotiations. I hope that our discussion today will also begin to help define the key issues of franchising that might be incorporated in future trade negotiations.

[Mr. LaFalce's statement may be found in the appendix.]

Chairman LaFalce. Today's panel offers a distinguished group of representatives of Government and business organizations which have significant direct experience with franchising. Their interests and experience range from the broadest aspects of franchising internationally to the technical aspects of the contractual relationship between individual franchisors and franchisees.

Our first witness will be Alex Konigsberg, a private franchise attorney with the firm of Goodman, LaPointe and Ferguson in Montreal, Quebec. Mr. Konigsberg serves as chairman of the International Franchise Committee of the International Bar Association.

Mr. Konigsberg will be followed by Debra Bollinger, the director of the Securities Division of the Department of Commerce and Regulation for the State of South Dakota. Ms. Bollinger is the chair of Franchise and Business Opportunities Committees for the North American Securities Administrators Association.

Next we will hear from Mr. Rupert Barkoff, a private franchise attorney with the firm of Kilpatrick and Cody in Atlanta, Georgia.

Mr. Barkoff serves as chairman of the Forum on Franchising of the American Bar Association.

Mr. Barkoff will be followed by Mr. Neil A. Simon, the senior vice president of the International Franchise Association in Washington, DC.

The final witness today will be Mr. Robert L. Purvin, a private franchise attorney with the firm of Brown, Martin, Poller and McLean in San Diego, California. Mr. Purvin serves as a legal counsel to the American Association of Franchisees and Dealers, and to other franchisee groups.

To permit all witnesses ample opportunity to testify and reserve sufficient time for questions, I would hope that each of the witnesses could summarize their written statements and hopefully take approximately 10 minutes or so.

All prepared statements, however, and all accompanying statements will be incorporated in their entirety in the hearing record.

At this time, if there is no objection, I would like to insert the opening statement of the ranking minority member of the Small Business Committee, the Honorable Joseph McDade. With no objection, so ordered.

[Mr. McDade's statement may be found in the appendix.]

Chairman LAFALCE. Anyone else? Mr. Skelton, do you have an opening statement?

Mr. SKELTON. First, Mr. Chairman, I wish to compliment you on holding these hearings on franchising in our American economy. We all know that increasingly franchising is an attractive alternative to people who want to start their own businesses. Unfortunately, reports of franchising fraud have increased as well. It is appropriate, in my opinion, that the Small Business Committee investigate these claims to determine what action should be necessary, if any.

Mr. Chairman, I recently received a letter from a corporate attorney in Kansas City, which is adjoining the district that I represent. This lawyer lists his concerns about the franchising industry and gives some suggestions as to what should be done to ensure that the honest franchisee prospers in this time.

Mr. Chairman, I wish to offer exhibit A, this letter from Mr. Robert E. Mulloy, Jr., Kansas City, accompanied with a related letter which is attached thereto.

Mr. Chairman, I might say that this seems to be chapter two insofar as the international scene is concerned of America allowing franchises pretty readily, and then we see various stone walls American franchises run into when they attempt to go into other countries.

This letter from Mr. Mulloy points out a problem in Alberta, Canada, and I would appreciate that being accepted as exhibit A.

Chairman LAFALCE. With no objection, so ordered.

[The letter referred to above may be found in the appendix.]

Chairman LAFALCE. If there are no other members that wish to make any statement, we will go to the panelists.

[Mr. Conte's statement may be found in the appendix.]

Chairman LAFALCE. All right, Mr. Konigsberg, you are our first witness.

TESTIMONY OF ALEXANDER S. KONIGSBERG, CHAIRMAN, INTERNATIONAL FRANCHISE COMMITTEE, INTERNATIONAL BAR ASSOCIATION

Mr. **Konigsberg**. Mr. Chairman, I would very much like to thank this committee for extending me an invitation to appear before it. I treat it with the utmost of respect and I wish to apologize for not having prepared a formal written statement, but the constraints of time made that an impossibility. However, I have provided the committee with some written material to which I will make reference from time to time.

I would also like to point out that although I am chairman of the International Franchise Committee of the International Bar Association, I am here in my capacity as a private attorney practicing in the field of international franchising.

I might start off by commenting briefly on some of the statistics to which you, Mr. Chairman, have made reference, and which is included in the material.

Clearly, the United States and Canada are the two countries of the world where franchising plays a dominant role, with both countries having approximately 30 to 35 percent of the sales of all goods and services through a franchise outlet.

It should be worth mentioning that the other countries of the world where franchising has become an interesting part of the day-to-day business would include France where available statistics would show that approximately 5 to 10 percent of all sales of goods and services are made through a franchise outlet. Then following by Japan with approximately 3.7 percent, the United Kingdom with approximately 2 percent.

But what is abundantly clear is that over the last 5 to 10 years, franchising has become accepted and approved method of distributing goods and services, and accepted throughout most industrialized countries of the world, throughout Western Europe, throughout the Pacific Rim including Australia and New Zealand, and today in many South American countries.

Some interesting statistics on the international level. In 1988, there were approximately 60 foreign franchisors doing business in the United States. I think that is a little surprising as in the common parlance, one would expect that there are many more than 60, but there are only 60. Our available statistics show that.

Chairman **LaFalce**. How do we know that?

Mr. **Konigsberg**. From different studies that were done by—one was done by a report that was commissioned by the International Franchise Association. It is a thorough report and a thorough study.

Chairman **LaFalce**. Where do you go to get that body of information or statistics for foreign franchises?

Mr. **Konigsberg**. There is an actual report and it is cited in my material.

Chairman **LaFalce**. I understand there is a report, but where, when the report was put together, where did they go, where is the original source of information?

Mr. **Konigsberg**. I am not aware of that, Mr. Chairman. In Canada, on the other hand, of the approximately 1,000 franchisors, almost one-half are owned by U.S. companies. Approximately 20 percent of all U.S. franchisors have overseas operations, many of them, of course, with less than 25 franchises. I think that is still a significant proportion.

As far as the future of franchising on an international level, I personally have little doubt that in the coming years we will see a veritable explosion of franchisors extending their system beyond their boundaries.

This explosion will be fueled by two forces: one, the natural inclination of most franchisors to expand their systems into foreign countries; and second, and probably more important, will be an ever increasing demand from other countries including many underdeveloped countries not just for new products and services, but for the incredible know-how that franchising will bring to some of these countries, know-how specifically relating to the most efficient, a most efficient method of moving goods and services from one point to another.

I think this has been amply exemplified in the last few months by what is really an incredible interest that has been shown by certain Eastern Bloc countries, in particular by Hungary, Czechoslovakia, and Poland, to seek out such know-how.

Chairman **LaFalce**. I have to interrupt to tell you that in anticipation, this committee went to Hungary, Czechoslovakia, and Poland this year to explore the needs of those countries for entrepreneurial know-how.

Mr. **Konigsberg**. I might add, Mr. Chairman, that in addition to this entrepreneurial know-how, I personally see franchising playing a role in those countries in the privitization process.

They are many, many industries that are State-controlled that are looking to move away from State control and foresee excellent opportunities to using franchising as a method in the privitization process. I would be happy to go into or to discuss what role franchising can play in that process in greater detail at your convenience.

As far as international legislation is concerned, or legislation of different countries that impacts on franchising, I am sure this committee is aware that there are only two countries of the world in which franchise legislation exists—the United States and the Province of Alberta in Canada.

Franchise legislation does not exist in any other Province of Canada other than the Province of Alberta, however, I believe it is appropriate to bring to the committee's attention that on January 2, 1990, the French Government enacted legislation that would amount to disclosure legislation. It would force franchisors to make disclosure of certain relevant facts prior to the sale or the offering of sale of a franchise.

That legislation was included, or that particular piece of legislation was included in an extremely broad law that took up approximately 1 page of the act. The legislation makes no mention of franchising. It is not aimed directly at franchising, but it is aimed at any company or any individual who licenses the use of a trademark, so it will impact on licensing arrangements, distribution agreements, and any other similar agreements.

The appropriate regulations under that legislation has not yet come forth, and until those regulations come forth, the act will not be implemented.

Rumor has it, or informed opinion has it that if and when those regulations are published and the French act does come into force, it will be quickly followed by Germany, Belgium, and other countries of the European community. That legislation is really disclosure legislation.

I should also point out that over the last 10 years, franchise legislation has been introduced into four or five different countries. In 1986, I believe, franchise legislation was introduced into Australia.

In 1988, legislation was introduced in Sweden. Going back to 1979, legislation was introduced in the Province of Quebec, and most recently, this year legislation that would affect franchising was introduced in Brazil. In each and every case, that legislation was discontinued or allowed to die a slow death on the books.

Over and above that, I believe the attention of the committee should be drawn to the existence of the Block Exemption Regulation on franchising which was enacted by the European Commission approximately 2 years ago.

Again, the Block Exemption Regulation on franchising does not purport to regulate franchising. It was an answer to the proliferation of franchise agreements and franchise activities in the community which resulted in the implementation of the block exemption, facilitating the entry of franchisors into those countries making up the community.

I would be happy to go into the nature of the block exemption and how it works and what it was implemented for. I don't know if time would permit that.

Chairman LaFalce. I don't believe time would permit that specificity at this instance. We are looking merely for the broad overview. We want to get into the blocking and the tackling associated with the franchise arrangement in the United States.

Maybe I should have had you last, to give you the broad overview rather than first. I am very interested in what body of law within your country of Canada, covers the franchising relationship. Is it the Federal Government or is it the provincial government or it is a combination of the two?

Mr. Konigsberg. There is no Federal legislation that governs that relationship, the franchisee or franchisor relationship. There is no provincial legislation that governs that relationship other than Alberta.

When I say there is no body of law, there is an extremely large body of law governing the relationship of any commercial transaction or the relationship between merchants, or the relationship between a merchant and a consumer, but it is no general application, general commercial application, and not specifically directed to franchises.

There is no other country other than those I have mentioned—the United States and the Province of Alberta—that has legislation particularly relating to franchises. But if I may, Mr. Chairman, I just wanted to mention there is also an organization which is affiliated with the United Nations the International Institute for the

Unification of Private Law [UNIDROT], that has been studying franchising for the last 4 years.

I may, with your permission, because I think this has particular affect to U.S. franchisors, or to any franchisors franchising abroad, is the existence of a body of legislation generally known as technology transfer legislation. To my knowledge technology transfer legislation exists in almost every country of the world other than Canada and the United States.

In each case, it was originally enacted to deal with the licensing of patents and technology, serious technology, technology that would permit someone to build a factory, to produce very sophisticated type of equipment.

There were perceived abuses by some of the countries, of underdeveloped countries in that particular field, and in each and every case, legislation was enacted which gave to the government or to governmental agencies discretion in rewriting agreements.

Where there were royalty rates which were freely negotiated, let's say, between an American company and a company in another country, and these could be either struck or the licenser could be forced to renegotiate those royalty arrangements.

In certain countries, certain limits were put on royalties a licensor could charge. In certain countries, the ownership of know-how, you could not license know-how unless it was patented, you had to sell it, so that after the term of the agreement, you could not stop the licensee from making use of that know-how.

Unfortunately, for the franchising community, when franchising became popular in these countries and North American franchisors would try to do business in these countries, they were faced with governments who didn't know what franchising was, so the convenient slot was to slot franchising under technology transfer legislation.

Because of that, many franchisors going overseas are faced with the thrust of this technology transfer legislation which will not permit them to freely negotiate in many countries royalty rates or other fees that are payable, would not permit them to protect what is really valuable know-how after the termination of the agreement, would affect their right to use their trademarks in certain countries.

This is an area which very unfortunately, but because a vacuum existed in the knowledge of these countries as to what franchising was, it was forced to be slotted under this technology transfer legislation.

[Mr. Konigsberg's statement may be found in the appendix.]

Chairman **LaFalce**. There is no question that we need to address within our bilateral and multilateral discussions and negotiations the whole subject of appropriate franchising arrangements.

But there is also the question that we need to put first things first. Before going into great detail on international problems, we need to have a discussion of what the appropriate relationship could be domestically, within the United States, and perhaps within other countries too. I do not think you can put or should attempt to put the cart before the horse.

Let us put the horse before the cart right now, and let us turn to our next witness and here of the domestic issues confronting the franchising relationship.

In order to do that, we have Ms. Debra Bollinger who as I introduced before, she is now representing the North American Securities Administrators Association.

Ms. Bollinger.

TESTIMONY OF DEBRA BOLLINGER, DIRECTOR, SECURITIES DIVISION, SOUTH DAKOTA DEPARTMENT OF COMMERCE AND REGULATION, AND CHAIRMAN, FRANCHISE AND BUSINESS OPPORTUNITIES COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Ms. **Bollinger**. Thank you, Mr. Chairman and members of the committee. Good morning, I am Debra Bollinger, director of the South Dakota Securities Division and chair of the Franchise and Business Opportunities Committee of the North American Securities Administrators Association, [NASAA].

NASAA is the organization of the State and provincial securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level in this country. I appreciate this opportunity to appear before you this morning.

I would like to begin by commending you for undertaking this important exploration of franchise-related issues. While there is a wide and growing array of reputable franchise opportunities available to Americans, so too are there problem franchisors.

An example from my own State, South Dakota, illustrates how the State registration and review process works to weed out blatantly fraudulent or abusive franchise offerings.

Invest America wanted to market franchises for the operation of a financial planning business. Here were some of the problems that we found when we reviewed the disclosure document.

The company's president had been convicted of Federal securities fraud and had been the subject of Federal Trade Commission injunctions that enjoined him from engaging in a variety of fraudulent, unfair, and deceptive practices.

A member of Invest America's board of directors was a defendant in a major civil action alleging fraud and misrepresentation, and the company's financial statements revealed the inability of the company to fulfill its financial and other obligations to the franchisees.

Other pertinent information also went undisclosed in Invest America's franchise offering circular. South Dakota and several other States who review presale disclosure documents denied the franchise registration status to the firm, and in doing so, saved untold numbers of potential franchisees from the loss of their hard-earned savings.

Before I get into more specific comments, I want to share with you my concern that we must now be more vigilant than ever in overseeing the franchise marketplace.

As the prospects for recession grow, more and more executives and other employees will be squeezed out of their jobs or forced to take early retirement. Shrinking job opportunities turn more and more people toward other ways of making a living, including franchising.

Those of us at the grassroots level are alarmed at the prospect of a growing pool of made-to-order victims for what is referred to in my formal statement as the dark side of franchising.

You may want to note also that the State of Oklahoma in the past 6 months had 12 cases against these home made-to-order franchisors. The rule of thumb in State investment regulation is that fraud and abuse usually follows closely on the heels of an industry that is undergoing explosive growth. Unfortunately, franchising has not proven to be an exception to this rule.

There is another side to the coin of the fast-growing and reputable franchise community. This hearing is particularly timely, given the warning issued just last week in the Wall Street Journal, and I quote, "Fraud in franchising and the sale of business opportunities is on the rise, fueled in part by a faltering economy."

We may now be on the verge of seeing a new wave of fraudulent deals peddled to less-sophisticated consumers. The economy service sector is spinning off many low-budget franchises that can be run from the home.

The rising number of people working at home constitute a massive potential market for franchisors. As franchisors reach down into the ranks of less and less financially-sophisticated consumers, State-level officials are increasingly concerned that those least able to afford it now will be the targets of unscrupulous operators promoting so-called low budget franchises.

The State franchise regulation system is rooted in the traditional commitment of grassroots officials to protect consumers whenever possible before they part with their money, and in those cases where money is lost in a fraudulent deal, to marshal the enforcement resources needed to shut down the violator and seek restitution, if possible.

Today, 15 States have statutes which regulate the offering of franchises for sale. Thirteen of these States operate under similar statutes which require registration with a State agency and delivery of disclosure documents to prospective franchisees prior to the offer and sale of a franchise.

Registration laws are designed to prevent fraud in the sale of the franchise and disclosure laws are intended to provide each prospective franchisee with the information necessary to make an intelligent decision regarding the franchise being offered.

Compliance with State regulatory requirements generally is satisfied by filing the Uniform Franchise Offering Circular [UFOC] and other relevant documents with the appropriate State agency.

The UFOC is accepted in all the franchise-registration States. While there may be minor differences in individual State requirements, franchisors can handle these variances simply and easily by use of a State specific addendum page.

The States have a broad assortment of enforcement tools available under the franchise laws which allow them to move swiftly and decisively against violators.

For example, from 1983 to 1988, the State of Wisconsin took enforcement actions in 26 franchise cases. The actions included four criminal referrals, 2 injunctions, 14 orders of prohibition, 5 warning letters, and one assurance of discontinuance.

A review of the 1986-87 enforcement program of the California Department of Corporations reveals that its Division of Enforcement handled 147 franchise cases, resulting in 5 criminal actions, 42 desist and refrain orders, 12 registration denials, revocations or suspensions, and 2 injunctions.

Franchisees in registration States benefit tremendously from the private right of action granted under State law. A private right of action allows consumers to sue for damages when they sustain losses due to franchise law violations.

The experience of State regulators is that private remedies serve as a necessary supplement to Government regulation and enforcement actions in providing a deterrence for abuse.

Chairman LAFALCE. Let me interrupt you, Ms. Bollinger. Those bells that rang 5 minutes ago indicated that we had 15 minutes to cast a vote, these bells indicate we have 10 minutes to cast a vote. It is my intention, however, not to recess, and I will miss the vote. It is a motion approving the Journal.

Mr. SISISKY. No; it is on the budget.

Chairman LAFALCE. Then I will miss it. You may do what you wish. Please continue.

Mr. SISISKY. We're chicken. We're going to go vote.

Ms. BOLLINGER. An important goal of NASAA is the promotion of efficient and uniform State laws. There has been a steady review of the substance of State franchise disclosure regulations to improve them, promote legitimate industry and simplify the requirements of compliance.

In a major new development, the NASAA membership just last month approved the Model Franchise Investment Act, a measure that will serve as a legislative blueprint for States interested in adopting new laws in this area.

At the Federal level, the FTC's enforcement authority is limited to civil penalty actions and actions for damages on behalf of franchisees.

In the 8 years from 1979 to 1987, the Commission brought a total of only 15 enforcement actions. Efforts of the Commission to adequately oversee the franchise marketplace are severely hampered by scanty resources and a narrowly constructed mandate.

The FTC's Marketing Practices Division has a staff of just 65 and a budget that falls shy of $3.5 million. The low level of Federal enforcement activity is doubly disturbing, since the FTC is not empowered to stop fraud on the front end by screening out fraudulent and abusive offerings. NASAA is encouraged by signs that, under the leadership of FTC Chairwoman Janet Steiger, a new era of State-Federal cooperation will be forged.

We welcome the opportunity to foster increased uniformity and coordination with our Federal counterparts. While uniform and streamlined franchise regulation will always be one of our goals, we are equally committed to our primary mission—the protection of current and potential franchisees from fraud and abuse in the marketplace.

State and Federal disclosure and registration requirements have substantially improved the structuring of franchise offerings and

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have enhanced investor confidence in such opportunities. Fair and honest franchisors have been extremely successful under the existing system of franchise regulation.

These legitimate firms have absolutely nothing to fear from the existing reasonable regulations. In fact, good franchisors benefit from regulation that promotes a clean and fair marketplace, since the perception of such is critical to maintaining the confidence of potential investors.

Despite some claims to the contrary, there simply is no empirical evidence whatsoever that State regulation of franchising in any way impedes the development of legitimate franchising.

Mr. Chairman and members of the committee, we applaud your interest in exploring whether we have done all we can to safeguard the interests of investors and small businesspersons in franchise arrangements. Franchising has provided many entrepreneurs with the running start they needed to achieve success in the business world. But, we must be ever mindful that fraudulent and abusive franchisors have, for all too many citizens, turned the American dream into a nightmare. Thank you.

[Ms. Bolinger's statement may be found in the appendix.]

Chairman LAFALCE. Thank you. We will have the questions at the end, but since most of the members were here, we need about another 5 minutes for them to return, let me just ask a few questions now.

Is it true that only approximately a third of our 50 States have some type of comprehensive law to deal with franchise arrangements?

Ms. BOLLINGER. That's correct.

Chairman LAFALCE. What efforts are being made, if any, to see to it that the other States not only know what type of action should be taken, but take that type of action?

Ms. BOLLINGER. The NASAA Franchise and Business Opportunities Committee took on the project of developing legislation for the States that are interested in franchise regulation.

Chairman LAFALCE. That was the model that you adopted in August.

Ms. BOLLINGER. Right.

Chairman LAFALCE. All right.

Ms. BOLLINGER. We started that process back in 1988 when the problems in franchising started to become more pronounced, and many of our members had approached the former chairman, Ann Nobels, about model legislation because there was none that our organization had developed at that time.

We developed the Model Franchise Investment Act for that purpose, to develop legislation for the States to adopt, and we are promoting that legislation through our members. As a matter of fact, we have at least a half a dozen States, if not more, that are interested in offering it to their legislature next year.

Chairman LAFALCE. If there is to be additional legislation, one issue that must be raised is should it be at the State level or should it be at the Federal level. We do have some instances in which the FTC is now able to preempt the States.

Let me ask this: Of the franchisee arrangements that you are aware of, of the activities of the franchisors that you are aware of, what percentage of their arrangements involve interstate as opposed to intrastate activities?

Ms. BOLLINGER. If I had to give a percentage, I would say that probably in the neighborhood of 85 to 90 percent of all franchising, if not more, is done on an interstate level. South Dakota only has two local franchisors and their intention is, once they have developed their market more fully, that they will be interstate as well. So the intrastate nature of franchising I would say is very limited. It is mostly interstate.

Chairman LAFALCE. The tendency on the part of most State legislators is to think legislation dealing with the problem should be done at the State level, and the tendency of most Federal legislators is to think that the problems, if they are interstate, should be dealt with through Federal legislation.

Do you, either individually or in your capacity as representative of the Securities Administration Association, have a thought on that?

Ms. BOLLINGER. Yes; I do, personally and as a representative of NASAA. I have seen from my experience in both the franchising and the securities areas is that regulation is necessary at both levels—State and Federal Governments. Neither the States nor the Federal Government can do it alone. We don't have the resources necessary to protect our consumers from fraudulent activity and the FTC currently just does not have the manpower or the resources to handle it.

On a grassroots level, the States are much more close to the problem and are especially in the smaller frauds, able to handle it much more effectively than the Federal Government would be able to do.

I think the cooperative efforts that the States and Federal Government have undertaken on both the securities side of financial fraud and the franchising side of financial fraud have been effective in cooperatively trying to deal with the problems now.

We haven't dealt with all of the problems and I would be happy to see the FTC have more resources, but I don't think you can eliminate the States from that process.

Chairman LAFALCE. Of course, you cannot eliminate the States, you ought not to, and you cannot and ought not to eliminate the Federal Government. The question is what should the appropriate role be for each?

Right now, there is a de minimis Federal role and right now, actually, there is a de minimis State role, insofar as the number of States. They need to work together to find the appropriate working relationship. We also have to ensure that there is not a competition in laxity, that we do not create some dual system where shopping can take place to obtain more favorable treatment.

Ms. BOLLINGER. One thing I will comment on and perhaps franchisors will disagree, but a lot of the nonfranchise registration States benefit from the States that are doing registration. States that are close to a State that does regulate franchising and look at the offering documents do get the benefit of that.

Also since franchisors tend to operate nationally, they are being reviewed by the vast majority of registration States which have a much better document based upon the fact that there is this review going on.

Chairman **LaFalce**. It seems to me too that we should be interested in promoting the competitiveness and the productivity of these operations too, and that a uniform body of law would clearly enhance the efficiency, effectiveness, productivity, and competitiveness of these operations.

Whether that uniformity of law and harmony of law can best be achieved by offering a model to be adopted by the several States, or whether it can be best achieved by Federal action, of course, is a question that should be asked and answered. Do you have a judgment on that?

Ms. **Bollinger**. I tend to feel that the State law that we have developed in the model act is a good one to start from, and I agree with the goal of uniformity, but unfortunately, there always are different types of problems.

Sometimes there are variations in the law based upon problems that each State has seen. For example, in Florida they have a terrible boiler room problem in their securities area and so their State securities law is a little bit different than even some of their surrounding States based upon their experience and their type of financial fraud. So uniformity is a good goal, especially for registration provisions, but sometimes exactly the same law will not be appropriate in each State.

But I would certainly support more Federal regulation in this area and perhaps a floor-type of law for Federal purposes, with States able to provide greater levels of consumer protection.

Chairman **LaFalce**. One of the questions I have always had though, are uniform laws ever adopted uniformly?

Ms. **Bollinger**. It has not been my experience.

Chairman **LaFalce**. No; that's one of the difficulties. I remember the first encounter I had with a uniform law was the Uniform Commercial Code. I studied it in my law school days. I went to law school in Philadelphia and of course, Pennsylvania was the first State to adopt the Uniform Commercial Code. Then when I first came to Congress, product liability was a major issue. In fact, I had about 19 days of hearings on it, and we finally got the U.S. Department of Commerce to come up with a model code to be adopted by the several States, a uniform code.

It didn't happen. I knew it wouldn't happen, which is why I introduced that uniform model for the States as a uniform Federal code. But there is, even with a uniform Federal code, some room for State action, but not in a way that is going to hamper the efficiency, effectiveness, or competitiveness. That would have to be worked out if we ever did go further.

Ms. **Bollinger**. I don't think State regulation has in any way impeded the growth or competitiveness of franchising. Just look at its explosive growth.

Chairman **LaFalce**. I wouldn't have expected anything other than that, but I think we will go on to the next witness, and the next witness is Mr. Rupert Barkoff.

Mr. Barkoff.

TESTIMONY OF RUPERT M. BARKOFF, CHAIRMAN, FORUM ON FRANCHISING, AMERICAN BAR ASSOCIATION

Mr. **Barkoff**. Thank you, Mr. Chairman, and members of the committee.

Chairman **LaFalce**. I should say for those who have come in late, you are chairman of the American Bar Association's Forum on Franchising.

Mr. **Barkoff**. My name is Rupert Barkoff. I am a partner in the Atlanta-based law firm of Kilpatrick and Cody where I specialize in the field of franchise law. I am also the current chairman of the American Bar Association's Forum on Franchising, a 2,000 attorney group within the American Bar Association whose principal function is to educate its members in the field of franchising and to investigate and study matters within its responsibilities.

I have been practicing in the field of franchise law for over 12 years. My practice includes the representation of franchisee associations, individual franchisees, and numerous start-up franchisors. I have also served as special counsel for several national chains.

I am here today, however, representing a constituency of one—myself. The views and opinions I will be expressing today are my own, and do not necessarily reflect the views of the Forum on Franchising, the American Bar Association, or any of my clients.

There are two subjects I would like to address to you today. First, I would like to present to the committee a lawyer's perspective of the current regulatory environment for franchising, and I will divide that discussion into two parts. I will first focus on franchise sales regulation, and then on franchise relationship regulation.

Second, I will present my perception of some of the systemic problems caused by franchise agreements and the role played by the courts and the lawyers in the context of franchising.

First, let me address the subject of franchise sale disclosure. In a speech I made before the ABA's Forum on Franchising last fall, a copy of which I have incorporated into my written testimony, I made five observations based upon my experiences.

The current regulatory system was not all that bad, and even with the FTC's entry into the regulatory scheme in 1979, a somewhat happy medium has been reached.

Second, there is a definite lack of information on the deleterious effects the current regulatory system has on our economy.

Third, to date, the Federal Government has not devoted sufficient resources to protect franchisees who have been fraudulently induced into purchasing franchises.

Fourth, most of the differences between the various State statutes and regulations do not truly further the interests of any State. Rather they make the system unnecessarily complex, cumbersome, and costly. Finally, there were significant structural, human, and political barriers to achieving uniformity.

I concluded that speech by pessimistically noting that the barriers to uniformity could not be overcome absent a considerable but unlikely change in attitude by all of the players in this game, including franchisor and franchisee representatives, franchise lawyers, NASAA, and the FTC.

Chairman **LaFalce**. Let me just stop you right there.

Mr. **Barkoff**. Yes.

Chairman **LaFalce**. Let me look at some of these points that you have articulated in that speech and now. Definite lack of information, a lack of Federal attention and resources in the protection of franchisees, differences between various State agencies and regulations that do not further the interest of any State at all, but seem to serve no valid purpose other than making the system unnecessarily complex, cumbersome, costly, and therefore inefficient, less competitive, less productive, and the significant structural human and political barriers to achieving uniformity, something sought by the States but something you say will not happen absent a complete or partial preemptive move by the Federal Government. It sounds to me as if you are talking for a considerably greater Federal role in the franchising field, is that correct?

Mr. **Barkoff**. I think there either has to be more Federal role in the field, or I think there has to be better coordination through the States. What I hear from my colleagues in the field is that while they favor preemption, they favor the concept of disclosure. Many of the distinctions between the current State laws are relatively procedural in nature and yet they currently have a significant adverse effect on the cost that franchisors incur in going through the regulatory process.

I address this in my written comments. I also express in those comments a great fear about the Uniform Act that was adopted by the National Conference of Commissioners on Uniform State Laws, as well as the NASAA Act.

I think either of those, when they get into the legislative process, may further complicate the situation, and that is true, of course, if there are changes made in the existing States and what is the greater fear, would be if the statutes begin to proliferate into other States.

In speaking with colleagues on the subject, for example, franchisors will typically spend in the neighborhood of $1,000 to $3,000 to have a registration filed and processed in each State, depending upon the quality of the initial registration.

That would mean that a franchisor, under the current system, would incur in the neighborhood of $13,000 to $39,000, assuming those figures are accurate.

On the other hand, if legislation proliferates into other States, this cost would run from $50,000, $100,000, to $150,000, and I think based upon my own experiences in representing start-up franchisors, that would clearly knock many of them out of the market, and cause them either not to enter the market of franchising, or to look for alternative methods to distribute their goods and services.

Chairman **LaFalce**. Sounds to me if you are making a call, although not quite a clarion call, for national registration.

Mr. **Barkoff**. I think that is one thing that ought to be considered, either that or some sort of preemptive approach on the question of the registration process.

I also stated in that speech, and also in my written testimony, that I think the States serve a very valuable purpose in the area of enforcement, because the FTC, because of its limited resources, has been much more selective in its enforcement abilities.

As Ms. Bollinger aptly pointed out, I think the States have done a very good job, given their own limited resources, in getting down to the grassroots of many of the problems.

Chairman **LaFalce**. I can say it is possible to conceive of a plan where there is a national registration requirement enforced by the States, so long as we don't have an insurance system.

Mr. **Barkoff**. One of the other things that I mentioned in my paper, Mr. Chairman, was that an alternative to an actually federally supervised procedure would be some sort of national clearinghouse for the registration process, which would perhaps take into account the peculiarities of various State laws, but at the same time, provide the various benefits that a national system would have, including that it would reduce the amount of resources that States would have to devote to the registration process, and at the same time, I would hope improve the quality of examiner and thus the quality of the review.

Chairman **LaFalce**. It sounds like a compromise, if you couldn't get what you think would be most desirable. Please continue with your testimony. I interrupted you.

Mr. **Barkoff**. OK. I think that covers most of my comments on the subject of franchise sales regulation. Let me take a few moments to address franchise relationship regulation. There are only two things that I think can be safely said about the subject. First the situation is currently a quagmire, and second, I doubt that there are any quick-fix solutions that will be effective and politically acceptable to all the interest groups in the industry, given present attitudes.

On virtually all of the franchise relationship issues—termination, renewal, transfer, encroachment, freedom of association, and so forth—there are meritorious arguments in favor of more or less regulation.

Franchisors need flexibility and power in order to keep their systems strong. Franchisees need the comfort that they are not going to lose their livelihood and investments as a result of, or have their success threatened by, arbitrary or incompetent conduct by the franchisor. Both franchisors and franchisees need to be profitable for their systems to succeed.

It is not easy task to develop a regulatory system that can accommodate all of these interests. Both NCCUSL and NASAA tried to incorporate relationship provisions into their uniform and model acts.

Except for a covenant of good faith and fair dealing, and provisions restriction the franchisor's right to select the forum for litigation, the drafting committees of both groups found the affected constituents so wrought up over relationship issues that it would have been nearly impossible to accomplish their other goals in the registration/disclosure area without dissecting the disclosure issues from the relationship issues.

There are many good franchisors, but there are bad ones as well. I have no doubt that there have been many abuses in franchise relationships. I have heard about them in my own practice, and from other attorneys, and from other franchisees.

I have heard numerous stories about how franchisees have been coerced into waiving claims, making improvements to their units although not specifically required to do so by their contracts, buying products at inflated prices. Some franchisees have told me how they have watched their franchisors skim off their customers through territorial or other types of encroachment. There are also horror stories about franchisor incompetence and franchisors who bring nonviable franchise concepts to the marketplace.

How widespread are these abuses? I am not in a position to say. That would be one valid area of inquiry by this committee, keeping in mind that, for various reasons, it will be difficult to ferret out the coercive conduct of franchisors in some franchise chains, since franchisees might not wish to risk the ire of their franchisors.

Were these actions illegal? That too, is difficult to say. Should they be illegal? I think that inquiry would be better addressed by industry than lawyers.

In my mind, the whole problem in the relationship area stems from the fact that the franchise relationship is viewed primarily, although not exclusively, as a contractual relationship, and a franchise agreement does not present a level playing field.

Protectors of the concept of freedom of contract argue that since the franchisee signed the contract, he should be bound by the contract, absent fraud and the like.

I consider myself a strong proponent of the free market economic system, but I am troubled by this dogmatic adherence to the principle of freedom of contract. It is based on two assumptions of which I am skeptical. It assumes that franchisees are businessmen and therefore knowledgeable about commercial transactions. It also assumes that in the formulation of the contract, the franchisee received adequate legal representation.

One should be cautious when generalizing about franchisees. There are some very large franchisees that are highly capable of taking care of themselves. But the more typical franchisee, I suspect, falls more in the mom and pop category. He or she may never have been in business before, and a franchise may be his or her first plunge in that direction. He or she is certainly not as sophisticated as the franchisor with whom he or she is contemplating a long-term relationship.

I am also skeptical about the hypothesis that legally speaking the franchisee is well-represented in the franchise sale process. The franchisee is in a considerably different situation from the franchisor. Although, he too should have strong incentives to consult counsel, he typically does not and I am not sure exactly why.

Sometimes it is because the franchisor tells him the agreement is nonnegotiable. In other situations, the franchisee will be viewing the franchise acquisition with the assumption that he will succeed, and not looking at what Ms. Bollinger has called the darker side of the relationship.

He is not asking himself the right questions, whether through naivete, haste, or otherwise. The franchisee's failure to consult counsel may also result from the desire to cut costs or a fear or dislike of lawyers.

In the few cases where a prospective franchisee does consult a lawyer, the lawyer may find that he will not have the capacity to be effective. Sometimes the client brings in the documents after they have been signed. In other cases, the client advises his lawyer that he wants the best representation possible, even if it costs as much as $200. The lawyer may also be told that the document is essentially nonnegotiable, and therefore he should not spend much time in his review.

Chairman **LaFalce**. To what extent are these contracts negotiable in practice?

Mr. **Barkoff**. Generally I would say they are not negotiated. In a meeting with some marketing representatives in Atlanta on Tuesday morning, one of the marketing representatives asked exactly that question.

One-third indicated that they did negotiate it, and two-thirds that they did not. These were generally smaller either regional or local franchisors. I suspect if you talk with the more established franchisors, you would find that they have a very strong likelihood not to negotiate substantial provisions of the agreement.

Chairman **LaFalce**. Thank you.

Mr. **Barkoff**. A franchisee may also be hampered in finding competent legal counsel. Few attorneys are familiar with franchising. The American Bar Association has approximately 350,000 members, which represents approximately half of the attorneys in the United States.

Less than 1 percent of these ABA members however belong to the Forum on Franchising. Primarily for economic reasons, there is not a developed group of practitioners who represent franchisees on a regular basis in connection with franchise acquisitions.

The fact that franchise agreements are one-sided is nothing new and it is not that fact alone which I find so troublesome. My concern is that the pendulum is now swinging too far in the wrong direction.

There have been various legal bases that have traditionally protected the franchise, but these seem to be evaporating or incapable of maintaining a balance between interested parties.

Antitrust laws used to keep check on abusive franchisor behavior, but current judicial and administrative attitudes toward antitrust claims as well as the sheer cost of prosecuting such claims have now made this alternative unattractive.

In the shadow of this decline, some franchisee lawyers argued that a franchise relationship is a fiduciary one, but the courts have almost uniformly held this not to be the case.

Most recently, franchisees have argued that every party to a franchise agreement has an implied obligation to deal in good faith and fairly with the other parties. While many courts have adopted this implied covenant of good faith and fair dealing in principle, they nevertheless seem reluctant to apply it when the conduct in question is covered expressly by the provisions of the franchise agreement.

It is this almost unquestioning adherence to the concept of freedom of contract that invokes my fear in today's environment. Franchise agreements in recent years have been like amoeba. They keep growing in length and one wonders what can ever stop that growth.

The McDonald's agreement of 1980 was 14 pages. One of my colleagues was recently quoted in the New York Times as saying that the "the standard franchising contract he writes is now 75 pages, triple the size of a few years ago, as franchisors frantically try to stay one step ahead of the jury and cover all the legal bases at signing time." Quite frankly, I don't enjoy reading 75 page documents and I am sure most prospective franchisees don't either.

I am also alarmed by some of the rights that franchisors feel they need and by some of the obligations they are imposing on franchisees. These are spelled out in some detail in my written testimony.

[Mr. Barkoff's statement may be found in the appendix.]

Chairman LaFalce. Let me just stop you there. Now we are talking about the respective rights of franchisors and franchisees. Do you believe that it is appropriate for some level of government, whether the State or the Federal, to address itself to what some certain fundamental rights and obligations should be for the precise arrangements?

Mr. Barkoff. I haven't answered that question in my own mind yet, Mr. Chairman. I think it's a very difficult question.

Chairman LaFalce. That's why I asked.

Mr. Barkoff. My problem with existing legislation is that I am not sure that it really covers what I consider some of the true problems because I am not sure——

Chairman LaFalce. I am not talking about existing legislation. I am talking about potential legislation. Do you think that there is a certain type of relationship that exists that should be covered by legislation, certain kinds of relationships or activities that franchisors participate in and take advantage of the franchisee that should be prohibited by law, or should be precluded from contracts or made unenforceable, et cetera?

Mr. Barkoff. I think that's a valid inquiry by this committee. I think one of the problems I have in that connection is I am not sure of the extent of the abuses in the current system.

I have worked with several franchisee systems and I can say from my own experience, if you sat down with each member of the association, each of them would have their own gripe list. Some of them are relatively petty and most of them fortunately get worked out just through the normal course of business.

It has been my experience that there are not that many termination situations I have seen where the existing legislation really protects the franchisees.

The renewal legislation I find somewhat more troubling. I guess in the perfect world, I think that probably could be handled through a better type of disclosure, but I am concerned that franchisees simply just don't read the documents, or more importantly, they don't understand what they're reading. I think quite frankly many attorneys who are not familiar with the area read the documents and aren't familiar with them and the consequences.

Mrs. Meyers. Mr. Chairman.

Chairman LaFalce. Yes.

Mrs. Meyers. I am interested in your testimony and concerned that no one seems to have a handle on the amount of abuse that is taking place in this area. What is a proper forum to get the kind of information that we need? It seems like there are so many firms and so many franchisors involved that to say that this committee is the appropriate forum, in a way, yes, we are. We are a good committee to put a spotlight on the problem. But in your opinion, who should do this information-gathering?

Mr. **Barkoff**. It is a difficult question. I am not a statistician so I'm not sure I can really say whether I am qualified to answer that, but one of the problems I have seen is that franchisees and franchisors generally don't like to hang their dirty laundry out in the public. Therefore, as long as there a continuing relationship between the franchisor and the franchisee, the franchisee I think is going to be somewhat reluctant to go public with the problems he is having in the chain. Even in some cases, I suspect that a franchisee is going to be reluctant to speak about it after termination.

It was interesting, there was a franchise fraud out of California about 1½ to 2 years ago where the franchisor essentially followed the full registration procedure and the State officials did not pick up on that.

Several franchisees in the State of Minnesota were defrauded as a result, and the franchisees, even though they had no continuing relationship, did not want to be identified for reasons of public shame or perhaps it would just make them look bad in the public eye.

That is one of the problems of getting anything other than anecdotal testimony in this field. I think it is very difficult to get proper valuable statistical information.

Mrs. **Meyers**. This——

Mr. **Barkoff**. Excuse me.

Mrs. **Meyers**. No; go ahead.

Mr. **Barkoff**. Also one of the problems I have is some things I don't think rise to the level of what should necessarily be regulated. In some chains, for example, a franchisor may want to improve the chain and he has a franchisee who is perhaps not living up to the most current standard of quality, but he meets an adequate level of quality.

The franchisee may want to exchange or to expand in that situation, for example, but the franchisor says I don't think you're a fit franchisee for expansion because you haven't played by all the rules in the game.

I don't think I am in a position to say whether that is good or bad, but I know that these circumstances happen quite a lot, and I think that is the type of abuse that I think should be explored through direct testimony of franchisees and franchisors.

Mrs. **Meyers**. Is this an attorney's problem? I believe that you are or were associated with the American Bar Association?

Mr. **Barkoff**. I am chairman of the American Bar Association's Forum on Franchising, although as I mentioned earlier, these are my own personal views I am expressing today.

Mrs. **Meyers**. It seems to me that we ought to be able to draft a contract that people would be able to honor. I recognize that there are a lot of human experiences that you can't put into a contract ahead of time, but has the American Bar Association done any investigation as far as the extent of problems in this area?

Mr. **Barkoff**. I don't think we have from a statistical standpoint. I think the problems that exist are aired each year. My own group, for example, has a 2-day program each October devoted to problems in franchising where various issues are discussed in a public forum. The program includes both open plenary sessions and workshops where the issues are addressed.

However, it is not our purpose, the Forum on Franchising under the ABA, to come up with a recommendation to that effect. There are other committees within the ABA, I think four others, that deal with the subject of franchising.

In particular, the Antitrust Section has written several reports on some of the problems in the area. They have, for example, a monograph on the question of termination. It is a fairly lengthy document. In connection with the NCCUSL Uniform Act, they published a task force that was adopted by the ABA itself. I alluded to it earlier. It deals solely with the registration area.

They came to the conclusion that the Uniform Act adopted by NCCUSL was a good concept, but they were concerned about State legislatures. They might cherry pick the act so that the end product would turn out not to look like the ingredients, but something considerably different than the ingredients.

The ABA appointed an additional task force to study and monitor the act and to recommend to the ABA, if they find this adverse trend occurring, that the ABA revoke its approval of the act. The ABA has not really touched upon the question of regulation, franchise relationship regulation.

Mrs. **Meyers**. Thank you, Mr. Chairman.

Chairman **LaFalce**. Thank you. Let us now go on to our next witness, Mr. Neil Simon who is the senior vice president for the International Franchise Association.

Mr. Simon.

TESTIMONY OF NEIL A. SIMON, SENIOR VICE PRESIDENT, INTERNATIONAL FRANCHISE ASSOCIATION

Mr. **Simon**. Good morning, Chairman LaFalce and members of the House Committee on Small Business, my name is Neil Simon.

IFA is a trade association which represents more than 650 business format franchisors. We have served as the voice of the franchising community since 1960 and I welcome this opportunity to appear before you today.

With this committee's indulgence, I would request that the corrected version of my statement which is distinguished chiefly by the presence of IFA's logo on the cover be made part of the hearing record.

Chairman **LaFalce**. There are no objections.

Mr. **Simon**. The franchise method of distribution of goods and services is one of the most important forces behind the growth and vitality of small business today. With due respect to my colleague, Mr. Konigsberg, franchising is an American success story.

IFA shares this committee's concerns which have been discussed this morning regarding the relative paucity of data available on the role franchising plays in our economy and I might suggest we would fully support all efforts to augment currently available data.

Indeed, 2 years ago I testified before Mr. Eckart's subcommittee on antitrust, protesting the then present determination of the Office of Management and Budget to delete the Department of

Commerce's funding for the annual publication Franchising in the Economy which has been and continues to be the only source of data.

Subsequent to OMB's decision, which was not reversed, IFA's educational foundation moved to fill the void and the publication is now published by Horwath International, a large accounting firm in conjunction with IFA's educational foundation. Horwath, incidentally, has taken over data gathering and analysis and adopted the methodology employed by the Commerce Department.

In any case, the success of business format franchising lies in its careful balance of business interests. Franchisees remain independent business owners, afforded an opportunity to enter a proven business and enjoy the advantages of being part of a larger system. Franchisors, in turn, build the strength of their trademark and image through growth unavailable by conventional means of expansion.

Are there trade-offs? Most certainly. Can franchisees be fully independent-minded entrepreneurs? No; it is a contractual relationship revolving around the license of a bundle of intellectual property rights owned by the franchisor.

This arrangement is set out in the franchise agreement signed by the franchisor and the franchisee and it will provide for the payment of royalties by the franchisee based on gross sales. In turn, the franchisor provides marketing assistance, site selection, the trademark, marketing strategy and plan, and the like. The terms of these contracts vary from one franchisor to the next, according to the industry and format of the individual franchise system.

Within IFA, we have more than 50 industries represented. The only thing they have in common is a method of distribution called franchising. The flexibility allows franchise systems to meet the demands of the marketplace and compete with large, vertically integrated chains.

Members of IFA range from Hilton Hotels to Midas Mufflers, from Century 21 Real Estate to McDonald's, from H&R Block to Pearl Optical, and from Wendy's to Zeibart. Although these names may be familiar to you, the bulk of our members are small businesses themselves. Forty percent of IFA's 650 members have fewer than 25 franchised outlets, and each system is unique.

The stability of the business-format relationship is reflected in the only currently available data regarding termination, nonrenewal, and transfer activity, and that is from the publication Franchising in the Economy.

For the year 1988, it indicates that of the more than 13,000 franchise agreements up for renewal, 90 percent were renewed; of the more than 386,000 franchise-owned outlets, only 2 percent were terminated.

In 1986, which was the last year this particular piece of data was available, 98 percent of the franchisees that sought permission to sell or transfer their franchise, were permitted to do so.

Chairman **LaFalce**. What was the source of the data that you have just cited?

Mr. **Simon**. That was Franchising in the Economy, 1988 to 1990. That was the first year that it was published by Horwath International in conjunction with IFA's educational foundation.

Chairman LAFALCE. That's the document, but who compiled that information?

Mr. SIMON. Horwath International did all the data collection and analysis. We did not want IFA involved in this aspect of the report.

Chairman LAFALCE. Let me be more precise. It is my understanding that that data was based exclusively on information given to it by franchisors, is that correct?

Mr. SIMON. I believe that is correct.

Chairman LAFALCE. To what extent can we put reliance on the data that you have just cited?

Mr. SIMON. I don't have a good answer to that. Certainly there are reasons to question the methodology and the accuracy. I might add that there is now available——

Chairman LAFALCE. If we are trying to say that all is well, and we are only looking at information that even you say you can't answer how reliable it is, we should not make——

Mr. SIMON. All I would indicate is that regrettably it is the only data currently available and therefore I use it. I might add that under a recent change to the Uniform Franchise Offering Circular and particularly item 20, franchisors are now required to disclose the names and last known address and phone numbers of all franchisees that left the system during the previous 3 years.

If it was possible to get a statistically reliable sample of disclosure documents, there would be an alternative source of data that could be held up against the Franchising in the Economy so we would be better able to answer that question.

Chairman LAFALCE. That uniform suggestion rather than requirement is how old?

Mr. SIMON. It is a requirement of law. It is a requirement of both Federal and State law in those 13 registration States that we have discussed, and that change was effective January 1, 1989, as I recall.

Chairman LAFALCE. It is a requirement of Federal law for 13 States or for 50 States?

Mr. SIMON. It is a requirement of the Uniform Franchise Offering Circular guidelines which were developed by NASAA. However, the FTC ruled and made clear that for purposes of satisfying the Federal law, the use of that disclosure document is proper and I would say well over 95 percent of all franchisors use the UFOC format as opposed to the alternative provided in the FTC rule.

Chairman LAFALCE. They say number one, it is proper. They don't say it's improper, do they?

Mr. SIMON. I'm sorry.

Chairman LAFALCE. They say it's proper, but they don't say it's improper not to, do they?

Mr. SIMON. No; it is a requirement. Franchisors are required——

Chairman LAFALCE. But then, they do not collect that, do they?

Mr. SIMON. Franchisors have that data in their files.

Chairman LAFALCE. No; the FTC does not collect that.

Mr. SIMON. That is certainly correct. All I meant to indicate is that there is a UFOC——

Chairman LAFALCE. Do the States have to collect it?

Mr. SIMON. The registration States get the documents that have that information. To date, I am not aware of any effort to try to piece it all together to get another way of looking at the franchise industry. All I meant to indicate is that with this change, which was supported by the industry, there is a possibility of that.

Chairman **LaFalce**. OK. I just don't want to say this exists, therefore all is well in the world. This exists, therefore there are only 99 rather than 100 loopholes.

Mr. **Simon**. I understand.

Chairman **LaFalce**. OK, good.

Mr. **Simon**. The key to franchising success is a trademark. A franchisor generally invests considerable time, energy, and capital with the goal of establishing a reliable reputation for its product or service, because the essence of franchising is uniformity.

If you go to a McDonald's in Buffalo, the Big Mac should taste the same as the hamburger that you would get in Las Vegas or wherever.

Indeed, a franchisor's trademark becomes inextricably tied to a consumer expectation and becomes a valuable asset in its own right. A franchisee whose performance is below the standard set out in the franchise agreement, reduces the value of the trademark as consumers will quickly associate the substandard franchisee's product or services with all outlets in the chain.

For better or worse, the primary method the franchisor has to protect the trademark, both for itself and for the benefit of the vast majority of complying franchisees, is to exercise its contractual right to rehabilitate the substandard operator if possible, or sever the relationship in accordance with the terms of the franchise agreement.

The power to terminate in such situations is essential to the franchisor's ability to fulfill its contractual obligation to other franchisees of assuring reliability of product and service.

Nonetheless, franchise terminations occur extremely infrequently. A franchisor with cause to terminate generally provides the franchisee with an opportunity to cure, not out of benevolence but out of pure self-interest. A franchisor that terminates an experienced franchisee incurs substantial cost and more importantly, cuts off the flow of royalty income from the franchise.

As noted in the 1986 report by the American Bar Association Franchise Committee Task Force, it cannot be assumed that the bargaining power of franchisors in relation to franchisees is markedly tipped toward the franchisor in the broad range of industries in which franchising is used.

In some industries or markets, or in some particular franchise systems, franchisees may have considerably more bargaining power or sophistication than in others.

Chairman **LaFalce**. Which one?

Mr. **Simon**. One example that comes to mind was the recent acquisition of the Burger King system. According to a rather extensive article in the Sunday New York Times some time ago there was a management group and there was Grand Met from the United Kingdom.

My understanding is that the franchisees were not particularly happy or satisfied with the existing management, and when word got out to the banks of that fact, tipped the deal in favor of Grand Met.

In certain systems, franchisees have considerable leverage. Certainly in large systems where you have multiple unit owners, they can have a great deal of power. It varies greatly from one system to another.

In certain systems, I would certainly not deny that there is every appearance of troubled franchisor/franchisee relations, but I do not believe that that is systemic to franchising.

We believe that the system works. According to the U.S. Small Business Administration, nearly 65 percent of individual start-ups go out of business within the first 5 years of operation. By contrast, since 1971—and again I am relying on Franchising in the Economy for these figures—less than 5 percent of franchised outlets have been discontinued each year.

For this reason, legislative attempts to reallocate the business risks inherent in the franchise relationship threaten the equilibrium of a franchise system and ultimately erode the capabilities that franchisees exploit through their investment.

If I may now briefly comment upon sales regulation, about which there has been a great deal of discussion. I think you already have background that there is the Federal Trade Commission rule which requires disclosure. That was adopted in 1979. However, before the Feds got into the act, the States were there.

California adopted the first franchise law in 1971 and following this, 14 other States followed suit, and although that is somewhat less than one-third of all the States, it does cover a little over 40 percent of all franchisees.

With the exception of Michigan and Oregon, all of these regulatory States require the franchisor to register with the appropriate State administrator prior to the offer of the sale of franchises.

The committee should note, too, that Michigan until 1984 was a registration State, however, under the leadership of Governor Jim Blanchard, a task force was assembled to determine whether the burdens and expenses of registration were justified in terms of their benefits.

This task force, which included the State Attorney General, concluded that registration was unjustified and legislation was passed converting Michigan into what is called in the trade, a notice filing State. You put the State on notice that you are conducting sales activity, and open yourselves up to their full enforcement powers.

Part of that deal in Michigan was granting to the State Attorney General much greater enforcement powers, and that was something that had the full support of the International Franchise Association.

In the early 1970's legislation was also introduced in some States dealing with specific aspects of the franchise relationship, the most controversial area in business format franchising.

While trade regulation has become accepted as an appropriate means of addressing narrowly defined abuse in specific industries—petroleum, automobile dealerships—its application to business format franchising is widely questioned.

As I mentioned earlier, business format franchising is not, of course, an industry, but a method of distribution for a wide range of products and services.

The greatest attribute of this method is its adaptability which is precisely which makes it unsuitable for across-the-board relationship regulation.

This fact, as was alluded to earlier, was recognized by the National Conference of Commissioners on Uniform State Laws which stated:

> After more than 2 years of intense study and debate by the drafting committee which considered several drafts that attempted to list prohibited and mandatory practices, led the NCCUSL to the conclusion that a list of prohibitions could not be expressed in a manner that was evenhanded, economically efficient, or responsive to the interests of consumers and of other franchisees or business opportunity operators.

The growing State regulation of franchise sales with diverse and sometimes conflicting requirements led to NASAA's adoption, or in fact it was the predecessor or a predecessor of NASAA called the Midwest Securities Commission, of the Uniform Franchise Offering Circular guidelines.

They were intended to introduce uniformity into the disclosure process, and in fact a degree of uniformity has been introduced.

However, States interpret the UFOC requirements differently, and variation is imposed by statute, in regulation and sometime unwritten administrative policy, and there remains a lamentable lack of uniformity.

Although the UFOC ostensibly allows franchisors to use one document, 12 of the 14 registration States require approval of specific disclosure language and some States reject language mandated by other States.

A quick example, Mr. LaFalce raised the question of negotiation. Virginia expressly requires negotiation in its statute. New York, by administrative policy which has not yet been withdrawn, disallows negotiation unless a franchisor first reregisters its disclosure document before it consummates the deal. This, of course, has a substantial chilling effect on negotiation.

Additionally, franchisors are faced with divergent approaches to sales regulation expressed in comment letters from State examiners which may often require extensive changes to disclosure documents and franchise agreements.

New York State has never granted a registration in the 10-year history of the New York franchise investment law, without issuing at least one comment or what is called a deficiency letter. IFA believes that presale disclosure——

Chairman LAFALCE. Is that an A plus for New York, or is that an F minus?

Mr. SIMON. I think it depends on where you sit. New York is very proud of its record. Should you have the opportunity to have representative of the New York State Attorney General's office that administers that statute before you, you might ask them that question. In the franchising community does not put New York at the top of the list of States which have a climate conducive to franchising activity.

IFA believes that presale disclosure of material information to prospective franchise buyers is essential to make informed investment decisions, however, the incremental cost of State examination of offering circulars and agreements to comply with variations in statute, regulation, and policy is in many cases a unproductive diversion of funds away from enforcement, where it could be used more effectively to protect investors.

To the extent this committee addresses the adequacy of current enforcement efforts, and I would submit that that is certainly an appropriate avenue of inquiry, it might be noted that greater cooperation between the Federal Trade Commission and State enforcement agencies could yield benefits.

Development of a State-linked data base of Federal franchise registrations could, for instance, relieve franchisors of the burden of multi-State registration and lead to a focusing of limited State and Federal resourcing to eliminate fraud. In this regard, I commend to your attention an article from last Friday's Wall Street Journal about franchise fraud.

Let there be no doubt. IFA fully supports governmental efforts on all levels to improve and strictly enforce disclosure law to rid franchising of fraud.

In any case, the resulting lack of uniformity and predictability substantially increases the time and cost of completing registrations, amendments, and renewals.

For larger companies, with an in-house staff of lawyers and legal assistants, these compliance costs may be tolerable. For the overwhelming majority of franchisors that are small businesses themselves, the cost of compliance can be oppressive.

Franchisors typically incur tens of thousands of dollars in annual expenses merely to keep State registrations current, and this does not include the cost incurred by franchisors who must suspend all sales activity in a given registration State, while awaiting registration approval.

A company considering franchising as a method of expanding its business, must evaluate the various costs that will be incurred in developing and implementing its franchise program. Regrettably, prospective small, start-up franchisors—the innovators and entrepreneurs who are perhaps the most potent source of successful small business development—are discouraged by confusing regulation and high up-front costs.

Concerns about this complicated regulatory climate have led to various attempts to promote uniformity and improvement in franchise regulation. After 4 years of debate and work, the National Conference of Commissioners on Uniform State Laws adopted a Uniform Act in 1987.

The substantial effort expended in developing this Uniform Act have thus far been unavailing. To date, the Uniform Act has not been adopted by a single State.

NASAA itself has made significant efforts toward improving the disclosure available for perspective franchisees, notably through revision of the guidelines for preparation of the UFOC with regard to earnings claims.

It had been recognized by franchisees, franchisors, and State administrators that earnings claim information is helpful, if not essential to prospective franchisees, and that the then present disclosure rules strongly discourage franchisors from furnishing this type of information.

Importantly, the State effort was endorsed by the Federal Trade Commission which took prompt action to accept the revised UFOC as a means of compliance with its rule.

Nonetheless, there were problems in implementing this change regarding the earnings claim, specifically the States of Minnesota and New York did not come on board in the time frame established by the FTC.

Arguably, a franchisor with sales activity in those States was in the position of trying to decide which law to violate—the Federal Trade Commission rule or the registration laws and regulation in those two States.

That prompted the FTC in 1988 to initiate a rulemaking proceeding to determine whether it should consider preemption. IFA initially took the position that the FTC should consider preemption only as a last resort. We did not support preemption, and we expressed hope that NASAA would be able to bring a greater degree of uniformity to sales regulation and improve the disclosure process.

Regrettably, it was only shortly after the expiration of the public comment period on the FTC's proposed rulemaking that NASAA revealed its Model Franchise Investment Act. There was no public discussion of the act by NASAA or its members during the comment period on the FTC rulemaking, and issuance of the model led IFA to request that the FTC reopen the public comment period.

Our supplemental comments expressed our concern that as then drafted, the model act would create new problems for franchisors without resolving the problems that exist under current law.

Fortunately, NASAA's franchise committee did meet in earnest with the advisory committee. It conducted a hearing in Baltimore and portions of the act were substantially revised prior to its adoption this past August.

Nonetheless, neither the need for State registration nor the need for a model State law was ever discussed by NASAA. Inasmuch as NASAA's franchise committee does not apparently contemplate use of the model act by existing registration States, but is holding out there as a model for other States, it is far from clear right now whether the act will lead to greater uniformity, or indeed, exacerbate existing problems.

But there are positive developments, including this committee's interest in franchising. Following years of discussion, NASAA's franchise committee under Ms. Bollinger's leadership, is expected to release shortly a State addendum project which she referred to, which in certain cases should allow franchisors to use a uniform code disclosure document with State-specific addendum.

NASAA is also examining means of simplifying the UFOC to make disclosure more effective. Importantly, the Federal Trade Commission which suffered under the cuts of the last decade, has in recent years, significantly increased its enforcement efforts.

Chairman LaFalce. Mr. Simon, I am going to have to ask you to try to conclude shortly.

Mr. Simon. It is clear that franchising is at a crossroads right now. Many basic issues have been reopened for discussion and this committee is certainly playing an important role in that.

On behalf of the International Franchise Association, I would like to say that we are certainly prepared to play a constructive role in the formulation of sound public policy. Thank you very much.

[Mr. Simon's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Simon. I think that was very constructive testimony, and I just want to make sure, before we go on to our next witness, that I understand what you said.

You said that you opposed the FTA rulemaking when they first came out, but this was because there had been no uniform body of law that had been agreed to by the States, and second, what they were discussing in your judgment was quite deficient.

But now you have praised the most recent model law that they have suggested, that is August 1990, and you cast great doubt as to whether this uniform law would be adopted by very many States, and if it is adopted by any, whether it would be adopted uniformly.

That sounds to me as if you are almost pregnant, not quite. It sounds to me as if you might be at the threshold of making a major break from past policy of the IFA, that you might be saying, given an appropriately drafted law, it should be done on the Federal level, and should be either totally or partially preemptive of other State action. Am I drawing an appropriate inference from your remarks?

Mr. SIMON. Two responses. One, if I gave you the impression that we were praising the NASAA model act, I miscommunicated.

Chairman LAFALCE. Heaven forbid, heaven forbid.

Mr. SIMON. It is very well-drafted, but we are not sure what, indeed, it is going to lead to.

Chairman LAFALCE. OK.

Mr. SIMON. With regard to the——

Chairman LAFALCE. But you are not criticizing it as you did before.

Mr. SIMON. I think that is correct. We pretty much have a wait-and-see attitude. We want to see what goes on in the States, and whether indeed, the model act has the potential—this is not clear—to bring uniformity.

With regard to the very basic and sensitive issue of preemption, IFA has not changed its position in that regard. We think that if greater uniformity is not obtained, that is something that will have to be looked at.

We, at this time, have no position. However, I would be disingenuous if I did not say that there is debate in the franchise community, and I think it has been evidenced by this panel today, on that very issue. I am sure these hearings and any action that you might take may play a role in that.

Chairman LAFALCE. I can assure you that there will be further hearings and therefore considerably further debate on this issue. It is extremely important. We are just beginning to become aware of the franchising domestically and internationally.

As soon as we hear from Mr. Purvin, we will return to the international scene, Mr. Konigsberg. But now let us turn to Mr. Purvin for another distinct and different perspective.

TESTIMONY OF ROBERT L. PURVIN, JR., ATTORNEY

Mr. **Purvin**. Thank you, Mr. Chairman. As a legal practitioner that has spent better than 17 years now dealing with the day-in and day-out travails of both franchisors and franchisees, I am sincerely most grateful to the chairman and to the committee for extending to me this special privilege of sharing my own observations, experience and frustrations born in a career of franchise law.

I would like to apologize to the committee somewhat for the homegrown nature of my prepared statement. I only received my invitation to appear while on vacation, and I borrowed a home computer to prepare my written statement.

I am told however, Mr. Chairman, that this will be forgiven since my vacation happened to be in your district.

Chairman **LaFalce**. Where were you?

Mr. **Purvin**. Niagara Falls.

Chairman **LaFalce**. You are most forgiven.

Mr. **Purvin**. I loved it.

Chairman **LaFalce**. Take all the time you want.

Mr. **Purvin**. I come to the issue of franchising, Mr. Chairman, from what I think is a very balanced perspective. I too, as several of the witnesses today have indicated, speak only for myself. In fact, I am quite hopeful that a number of constituent clients of mine do not ever hear of the views I am about to express before the committee.

But I am greatly enamored of the institution of franchising, and yet over recent years, as Mr. Barkoff talked about the pendulum swinging too far in one direction, I have been increasingly concerned over the significant imbalance of power—imbalance of power in the marketplace between the franchisor community and the franchisee community.

So I hope to document the very serious problems at this beginning stage. I also would like to comment to the committee on just an excellent presentation in the committee's report on the status of the industry and the issues in the industry and the history.

I really sincerely state to the chairman that this report is the very best summary I have ever read, and I used it as a starting place in my written comments, and did not go over the same ground that the I thought that the committee's report did quite ably.

I would like to go back a step from where most of today's witnesses have begun, where we have heard a lot of statistics about the dynamics of franchising, but to go back to the roots of franchising and why it is such a miraculous system of distribution.

First and foremost, and a quality which must be preserved, franchising is an entrepreneurial tool for effective business expansion. Franchising is a technique for business expansion and is not only important to franchisors, but important to the economy as a whole.

Franchising has grown to be an enormously effective system for many important industrial functions. First and foremost, is product and service distribution.

Chairman **LaFalce**. Pardon me.

Mr. **Purvin**. Product and service distribution. The second most important—and the way I happened to become involved franchising—is as a tool of capital formation.

I began my legal career in helping companies raise capital and first discovered franchising as an incredible mechanism for which a company could grow its business without having to dilute share ownership, without having to go to banks, and in fact, the company was usually unable to go to banks because it did not have the assets to support typical lending practices.

Through franchising, companies are able to incorporate off balance sheet capital growth, and in fact, through the franchising system, have the good fortune of having the franchisee provide the capital and pay for the privilege through on-going royalties! It is a marvelous system for that.

In terms of the benefits to the economy, franchising provides an enormous potential for vocational training. One of the witnesses, I think it was Ms. Bollinger, talked about the fear of State regulators of an enormous number of people coming into the job market and needing training and wanting to provide regulation in that area, but the importance of the vocational training that franchising provides is a key element and benefit from the industry.

It provides for rapid business and system expansion, low risk, off balance sheet financing for both capital and labor improvements, provides the effective recruitment of motivated, dedicated, own-your-own-business managers.

It provides for, as I believe Mr. Simon talked about, the packaging of intellectual properties and has created an incredible American, uniquely American, industry capable of exportation, which of course very important to us and goes to some of the topics of Mr. Konigsberg's talk.

Generally, franchising has provided an effective design for business management for many industries requiring stable management at remote and varied locations. This is a very important aspect, and very important for us to realize as we begin this inquiry, that this is an industry that is of paramount important to our country, to our economy, and needs to be constantly improved.

My concern is that as franchising becomes more and more one-sided, and as franchisors—and I don't mean to imply that franchisors are at all bad guys because they have become powerful—become more powerful, power, as it always does when it is one-sided, tends to corrupt.

What is missing in the marketplace is the competitive voice of franchisees that are able to come forward and match the power of the franchisor organizations that speak eloquently for one perspective of franchising, to create the stable balance in the marketplace.

I, as Mr. Barkoff said, am a great believer in the ability of the marketplace to ultimately address the issues. The turn of the century in this country——

Chairman **LaFalce**. But the contractual relations negate the force of the market.

Mr. **Purvin**. This is absolutely correct, and as I say, over time, and I was going to use the example of the labor movement in this country where there was an incredible imbalance of power, and over time, as labor unions built up, that balance and maybe the pendulum swung even more on the side of labor in the mid-60's and mid-50's.

Chairman LaFalce. We call franchisees small business owners. In a sense, though, could other people call them employees.

Mr. Purvin. Still others could call them indentured servants, Mr. Chairman.

Chairman LaFalce. Yes; so would we be talking, if a group of franchisees got together, of a trade association of franchisees, or would we be talking of a labor union? Or does a franchisee have aspects of both, and therefore, because of that need unique treatment?

Mr. Purvin. Certainly franchisees have aspects of both employee and independent contractor. You have never seen an employment agreement, you have never seen an employment relationship as well-defined and as well-organized and controlled as most franchisee relationships.

I have never seen an employment agreement that ran 75 pages. The franchise agreements I produce in my office are short of that size, but only just short. They are bolstered not only by the 45–75 pages of the franchise agreement, but of several hundred pages in most instances, in sophisticated franchise systems, of standard operating procedure manuals which are incorporated into the franchise agreements.

So you could say there are aspects of an employee relationship. There is a major franchisor of convenience chain stores, whose franchisees don't really even have control over the funds that are deposited into the stores coffers. They go into a franchisor account and paychecks are written every month at the same time that vendors get paid.

I am not necessarily critical of the practice, but I am agreeing with the chairman that there is a lot of instances where you can draw the relationship of employer/employee.

The importance is that over time there needs to be an ability of a franchisee voice, both on a national and local level. I have been privileged to be involved with a group of franchisees and former franchisees that have taken an effort to——

Chairman LaFalce. Just out of curiosity, has any labor organization ever attempted to organize franchisees?

Mr. Purvin. I am not aware of a labor organization per se, Mr. Chairman. There have been several attempts at a national franchisee association. None of them have been successful to date, including the one that I have been initially involved with.

Part of the reason is that there are some successful franchisee associations within individual franchise systems. You asked Mr. Simons for examples, and one that came to my mind is the Midas Dealers Association which over the course of a number of years—following many hard battles—has forged a mutual respect and strong friendship with its franchises, in recognition of the success of the competitive process. Working the way we like our free market system to work, franchisee associations can work with franchisors toward building a stronger franchise system for both franchisor and franchisee.

Once competitive balance occurs, I think we will have a greater ability for reliable statistics. I think one of the problems in our industry is that franchising statistics are very one-sided, coming from the only voice that exists, this being the International Franchise Association, for which I admire quite a bit as a model organization, as a very well put together and administered organization, but all the statistics or the great majority of the statistics that we receive are all tainted from the franchisors' perspective.

I don't mean to use the word taint as in a bad sense, but they are colored by the franchisor's perspective, and we are not seeing that balance from the franchisee's perspective.

So ultimately what we have to work toward is a system where the pendulum swings back the other way. We have to ultimately not only allow for negotiation, but create a climate in which there is effective negotiation.

I believe competitive balance comes from the development of an association like the IFA to speak for the interests of franchisees, to provide for accreditation of franchisors that meet the standards of fair franchising that such an association could consider, and to test the statements made on the side of franchisors as well as franchisees.

There has been a lot of discussion, Mr. Chairman, as to the use of disclosure statutes in the framework of franchise regulation. I am skeptical of disclosure statutes and I am skeptical of the emphasis on disclosure statutes as being the mechanism in which government, both Federal and State government, can come in and provide assistance to franchisees.

I think the most important areas of Government regulation is not more disclosure, but putting teeth into the disclosure. I was very pleased when I first read the model act, and pleased when I recently read the model act that has been suggested by NASAA in its final version, that there is a provision for a private right of action, that there is a provision requiring the ability of negotiation of franchise agreements, and most specifically, from my day-in and day-out experiences of my own practice, that franchisees are given the right and the local jurisdictions are given the right to have their local law apply and their venue requirements apply to protect franchisees. I would hope that those restrictions apply to arbitration as well as to legislation through the normal court system.

Chairman LAFALCE. Could you conclude shortly?

Mr. PURVIN. Yes; thank you. So I think that where Government's most important avenue of protection at this time, at the first juncture, is making sure that franchisees have a private right of action to address disclosure abuses, and that we be careful about disclosure, because disclosure laws I find to be more exculpatory than protective.

The exculpatory effect of disclosure is something that nobody has addressed today, and I hope we can address it in the question phase. Disclosure tends to shield the franchisors from claims of misfeasance more than to provide meaningful disclosure to franchisees. As Mr. Barkoff testified, franchisees rarely review the totality of the disclosure or have adequate counsel to make that review for them. Thank you.

[Mr. Purvin's statement may be found in the appendix.]

Chairman LAFALCE. Thank you. Ms. Bollinger and gentlemen, you have all been outstanding in your presentations. I mean that quite sincerely, and you have raised scores of questions that we shall be contemplating in the months ahead.

I can assure you that if I am reelected this November, and if I am then reelected chairman of the Small Business Committee, that the subject of franchising will be a major concern of the Small Business Committee.

I would have liked to have made it a major concern this year but there was simply an inability because of the constraints of time because I was chairing a task force of the banking committee, in addition to being chairman of the full Small Business Committee.

But I wanted to put my foot in the water before the end of the year, and to clarify what we would be contemplating in the next Congress.

Our report, and I thank you for your kind comments, Mr. Purvin, regarding that report, if there was any deficiency in the testimony of the others, it was that they didn't make the same type statement. Some of which they will be forgiven for. I wanted to send messages to say we are going to be considering this seriously.

Our primary focus will be the need for a body of law, the need for uniformity, the appropriate relationship which should exist between the State and the Federal regulation.

Our primary focus within that area of law will be registration, but a second and very important consideration will be the appropriate legal relationship which should exist between franchisor and franchisee.

I do not think it is enough to consider the one without considering the other, although it might be easier to pass the former than the latter, and I am cognizant of that fact.

Although I do not want what I am about to say to diffuse what I have just said, I am also intrigued by the tremendous potential for franchising not only domestically but internationally. Mr. Konigsberg, I arguably believe that the franchising technique can be perhaps the primary means of assisting developing countries, and as I said before, those countries that previously had a planned economy and are now going to a market economy, both in the development of an entrepreneurial sector, and also in the privitization of State-run industries.

We may even put our foot in the water in a few weeks and have a special hearing on that, although I do not want anyone to lose sight of the fact that my primary focus will be on the domestic front with respect to the laws dealing with registration and contractual relationships and offshoots of that.

Having said that though, Mr. Konigsberg, if I were to sit down with Carla Hills and John Crosby, our respective trade ministers, and say let us discuss franchising between the United States and Canada, what subjects would be fruitful subjects for both discussion and negotiation and agreement?

I started off with examples that are bilateral rather than a multilateral in scope, because in Canada and the United States, we have the two most developed franchising countries.

Mr. **Konigsberg**. Mr. Chairman, from a Canadian perspective, it is very interesting that the FTA, the free trade agreement between our countries is one of the only Canadian statutes in which the word franchise is used.

Franchising is specifically recognized by the FTA as a trade in services. I have done quite an extensive study on the application of the FTA to franchising. Unfortunately, there is not much meat in it.

If I would have to answer your question directly, it would be certain indirect recommendations, or for example, in immigration, one of the big problems that franchisors both in Canada and the United States have in doing business in other countries is the ability to send staff people over to the other country and have them provide the training, supervision, et cetera.

The word has yet not filtered to the people manning our respective borders that there is a free trade agreement in effect, and it is extremely difficult for franchisors in one country to send their people over for a period of time to do the proper supervision.

The other area is that there should be, I would suggest, certain clarification of what really falls under the FTA and what falls under GATT.

There are still certain products—for example, yogurt which quickly comes to mind, which is just totally exempted from FTA, and yogurt cannot be freely imported into Canada. There are quotas on it.

Chairman LaFalce. We exempt yogurt from the FTA?

Mr. Konigsberg. Yes.

Chairman LaFalce. That escaped me.

Mr. Konigsberg. There are other products of that nature.

Chairman LaFalce. Counsel wants to know whether that is lowfat yogurt also.

Mr. Konigsberg. I think that was exempted at the instigation of the Canadian Government and not vice versa. One reason for most years, milk products cannot be imported from Canada into the United States. This was sort of a retaliatory thing.

I understand that GATT has opposed that and overrun it and it is now subject to appeal, but there still many areas of that field which are just unclear with regard to FTA.

Chairman LaFalce. You were chairman of what? The International Franchise or the bar association? Tell me again.

Mr. Konigsberg. International Franchise Committee of the International Bar Association.

Chairman LaFalce. OK. What are the issues that you discuss when you meet? Should these be the issues that are discussed? I don't want to jeopardize your tax break, but I assume that you discuss these substantive issues. Are these the same issues?

Mr. Konigsberg. No; I appreciate your consideration. The issues that are discussed really are peculiar to international franchising.

Chairman LaFalce. I mean are these the same issues that should be——

Mr. Konigsberg. No.

Chairman LaFalce. At a round of GATT?

Mr. Konigsberg. Unfortunately, to my knowledge, and throughout the history of this particular committee, those issues have not been attended to. The issues that have attracted attention are efforts by international bodies or countries to enact franchise legislation, and you raise the questions about labor unions.

I believe in Sweden the legislation which was introduced in 1988 in Sweden was labor-union intended, or it was at the instigation of the labor unions. Frankly, what it said was that any franchisor could not make changes in the system unless he negotiated it with the employees of all its franchisees.

That legislation never got off the ground, but those are the types of issues, the UNIDROT initiative, as to uniform legislation that would impact on franchising on an international level, problems of termination, Mr. Chairman, which is really I understand, a problem that concerns this committee a great deal, on the international level, it is much, much more important on how it is to be treated.

Chairman **LaFalce**. You mentioned unions. I was thinking of an analogy of a union to an association of franchisees. But is there or has there been any attempt to organize the employees of the franchisees in order to deal either with the franchisees or to deal with the franchisors?

Yes, Mr. Simon.

Mr. **Simon**. If I could just point out a practical problem. Inasmuch as franchisees are responsible for the hiring and firing practices of each individual franchise, the benefits——

Chairman **LaFalce**. Is not this in some way covered by the franchisor in the relationship and aren't there certain norms?

Mr. **Simon**. No; this is indeed the primary feature which renders franchisees independent contractors, that they do have control over the hiring and firing process. Indeed, a franchisee within a given system may be paying or offering a package of benefits to employees that differs from a system operating under the identical trademark in the next town.

So I think there are some limits to the management/labor analogy. In terms of possible unionization of franchisees employees, perhaps it might be practical for employees of a single franchisee or multiple-unit owner. But throughout a system, I do not believe it could work and I am not aware of any attempt, at least in this country, to do that.

Chairman **LaFalce**. Nor am I suggesting it.

Mr. **Konigsberg**. After hearing the testimony of the different individuals on this panel, I wonder if I could share with you another experience also involved in Sweden where they have been studying the possibility in Sweden, which as you know is an extremely paternalistic country, the possibility of introducing a standard form franchise agreement.

My understanding is that after much study, all they could agree on would be a standardized seven or eight clauses, in an agreement that might have 50 or 60 clauses in it, because of the disparity of the system, and those clauses which they could agree on standardizing were the clauses that really were not relevant.

Chairman **LaFalce**. Is there any State or Government that requires submission of the standard contract used by the franchisor or review by say, a State attorney general?

Mr. **Purvin**. Yes; California. California carefully reviews the franchise agreements of registering franchisors and required disclosure of specific elements. Frequently the comments we get from the State regulators are telling us we have not adequately disclosed particular information, but usually, it is we have failed to disclose that noncompete covenants are not necessarily enforceable in the State of California because they exist in the franchise agreement.

Ms. **Bollinger**. It is a standard part of the Uniform Franchise Offering Circular to attach all of the standard form agreements that will be used in the system by all registration States.

Chairman **LaFalce**. So that is what? A third of the States, is it?

Ms. **Bollinger**. We review those contracts.

Chairman **LaFalce**. Do you review them, the form contract not the final signed contract?

Ms. **Bollinger**. No; we don't.

Chairman **LaFalce**. Is there any State that requires a review of the final contract?

Mr. **Simon**. This was an issue in the State of New York in a recently litigated case that the State Attorney General lost, where there was negotiation between a major franchisor and someone seeking area rights for the Borough of Manhattan.

The franchisee wanted more favorable terms, the franchisor apparently was amenable and went to the State to amend their registered offering to reflect this deal. The State said thank you very much for registering this, because that is something you must do, but because you have been negotiating and that violates the New York franchise investment law, you must pay a fine and enter into an order of discontinuance.

That was litigated and the New York Attorney General lost, which is all the long way of saying that there are States which would require franchisors to reregister when there has been a deal negotiated that is different from that reflected in their Uniform Franchise Offering Circular. But this is a very large grey area and the effect is to, it provides a very strong disincentive for franchisors to negotiate.

The only other thing I would mention is negotiation appears to be more prevalent where you have a very sophisticated investor with a large up-front cost.

For certain systems with a low franchise fee, the mere transaction costs of negotiating individual deals are just too great. But the State regulation in the area of negotiation is a grey one. Some States expressly permit it. The NASAA model act expressly permits it because it is something that should be encouraged, but there are other States like New York, where you do it at a great risk.

Chairman **LaFalce**. What is the standard redress mechanism for violations of either the letter or spirit of the contract?

Mr. **Simon**. There is a great range going everywhere from court——

Chairman **LaFalce**. Is there an arbitration panel set up?

Mr. **Simon**. There is recession. Recession is a very common remedy under State registration laws, putting the franchisee back in the position he or she was before they entered into that relationship.

Chairman **LaFalce**. My point is has any State set up arbitration panels in the first instance.

Ms. **Bollinger**. States themselves don't set up arbitration panels. You may know because of the fact that there is sole Federal jurisdiction over this issue explicit in the Federal Arbitration Act, and this seems to take us out of the ballgame when it comes to arbitration.

Chairman **LaFalce**. Can a franchisee who has a problem with a franchisor, or vice versa, go to a Federal arbitrator in the first instance?

Ms. **Bollinger**. Most of the standard contracts these days require arbitration to occur if there is a problem with agreements.

Chairman **LaFalce**. Who would the arbitrator be?

Ms. **Bollinger**. Whatever forum is set out in the contract.

Chairman **LaFalce**. Is it a Federal arbitrator?

Mr. **Barkoff**. No; usually it would be an independent arbitrator frequently appointed by the procedures set out in the American Arbitration Association's rules.

Chairman **LaFalce**. What Federal arbitration law are we speaking of? You were speaking of some Federal arbitration, weren't you?

Ms. **Bollinger**. The Federal Arbitration Act which grants the presumption that arbitration is preferred over litigation.

Chairman **LaFalce**. It creates a presumption that arbitration is preferred, but suppose the franchisee says that may be a presumption for the rest of the world, but it is not for me, I want to go into court.

Or suppose there is a contractual arrangement that nullifies that presumption. What is the body of law?

Mr. Barkoff?

Mr. **Barkoff**. It is a matter of contract law generally. If there is no provision in the contract agreement for arbitration, neither party is required to go to arbitration by any law that I am aware of in the general field of franchising.

Chairman **LaFalce**. But isn't this a standard provision within most franchisor contracts?

Mr. **Barkoff**. No; I wouldn't say that is the case. I would say it is probably less than 50 percent. I think they are becoming more common in the recent agreements. I am not aware of any statistics. Maybe Mr. Simon is.

Mr. **Simon**. I am not aware of statistics. It is going to be a feature of the upcoming American Bar Association Forum on Franchising program. There will be a debate on the merits of arbitration versus litigation and minitrials, but the dispute resolution mechanism is generally spelled out in the franchise agreement. I am not aware of any uniformity with it, and the merits and demerits of arbitration are is argued about endlessly.

The Federal Arbitration Act comes into play and the preemptive impact of it, when you have a State like Minnesota which still at this moment, by administrative policy, does not permit the inclusion of binding arbitration provisions in franchise agreements.

That strikes me, and IFA has communicated this to the Minnesota Department of Commerce, as violating the Federal Arbitration Act and a number of cases that have come down under it.

I understand there is some reassessment in that State of their position. But States take an action which would discourage the resort to arbitration, that violates the Federal Arbitration Act.

Mr. PURVIN. Mr. Chairman, if I may, this area of inquiry to me is maybe initially the most important of what a franchisee's right of redress is.

In those States that do not regulate franchising, there is no private right of action for violation of the FTC rule which is probably the largest failing of the FTC rule, but the biggest problem is the franchise agreements deal with these clauses, and even in the case of the largest franchisees that are capable of negotiation, they are dealt with in clauses that are at the end of the agreement, that appear to be innocuous, and yet they are of the most critical nature.

Not only do I have a right to bring redress, but where do I have that right? What forum am I allowed? It seems to me that these are areas in which the Federal Government can come in and set down standards that, whether it be arbitration or litigation through the normal means, is not to me the primary issue, I think that arbitration is utilized as a mechanism to circumvent the ability of a State to control the affairs of its own citizens.

If the Federal Government could come forward and talk about venue and talk about a private right of action for violation, and to talk about the choice of law standards that apply, that this would be enormously beneficial immediately to curb abuse in the interim, while franchisees are trying to muster their own abilities to negotiate in the marketplace.

Chairman LAFALCE. I am going to have to bring this to a close because of the constraints of time and other appointments that I have, but this has been an excellent hearing, at least in my judgment it has been.

But there is one thing that always disturbs me about most business format franchises, and that is the lack of individuality, the lack of personality. I am just wondering what the prevailing practices are, and if there is anything that is developing.

This is not true, say, for certain types of product franchises and auto dealerships. In an auto dealership you have Masanto Chevrolet, or a Paddock Chevrolet or whatever it may be, and then you go to a Skill Buick or Brown Buick. They have their own identify, although they are part of a franchise operation.

You go to other types of franchises and the are faceless, in a certain sense. They have no individuality. This, perhaps, has nothing to do with the law but just my own personal preferences. I hate going to faceless entities. I like going to entities with some personality. Is this a subject for discussion when franchisors and franchisees meet at all?

Mr. SIMON. What the franchisee is purchasing is that appearance of uniformity. Is it indeed——

Chairman LAFALCE. Is indeed pizza——

Mr. SIMON. Something that renders that person relatively anonymous, and that is the genius of franchising and that's why it works.

Chairman LAFALCE. Yes.

Mr. SIMON. You are right, that is the primary difference between dealerships which is a very different arrangement and franchises. There you have someone buying a product at wholesale, selling it at retail and getting the mark-up. That's where they make their money.

In business format franchising, you don't do that because what the franchisee is purchasing is a business format, complete with the trade dress and image. The whole idea is to make it identical to the one that is halfway across the world.

This is leading to a change in the appearance of a lot of small towns, but increasingly it is also the future of the small business because it is so hard to be a small business person in today's competitive environment.

Mr. KONIGSBERG. Mr. Chairman, I don't entirely agree with my learned colleague.

Chairman LAFALCE. He may be right. I may agree with him in that respect, but I just don't know that I like it.

Mr. KONIGSBERG. Because I think that although as you put it, it is still the same faceless person, I think individual franchisees have a great deal to contribute to their ultimate success, and within an operation.

Chairman LAFALCE. I wonder if the franchisor wants the faceless entity. I wonder if the franchisee wants that though.

Mr. KONIGSBERG. The other point, I think an individual franchisee does have his mark to make and can to some extent dictate the degree of his success.

The other thing is that franchising over, especially in the last 5 to 10 years, I have seen an incredible evolution from the point of view that the research and development that must be done in constantly upgrading and changing the quality, and changing the services being offered.

Originally, McDonald's offered McDonald's hamburgers. Today there is a wide range of products, and many of these are initiated by suggestions made by franchisees. There is a role for both parties to play.

Where I don't disagree with Mr. Simon is the fact that once it is set, and for that period of time that it is set, then uniformity is over the most paramount importance, but franchising and good franchisors are constantly doing major research and development to add products, subtract products, change products. I don't know whether that is an answer to your questions as to whether it is faceless.

Chairman LAFALCE. I suppose it is just a question of whether I would choose to go to a Pizza Hut or whether I would choose to go to Angelo's Pizza Hut.

Mr. KONIGSBERG. That's also franchised.

Chairman LAFALCE. Yes.

Mr. BARKOFF. Just as a matter of information, there is one industry, the real estate industry, where it has not been uncommon for the franchisee to keep at least part of his name, his own name, for example.

This industry was in large measure developed through conversion franchising where it took existing independent businesses and brought them under a common name, and sometimes in order to protect that identity as well as in some cases, because of local State statutes requiring that the broker have his name involved, it is not uncommon to find say Joe French's Gallery of Homes.

These are real estate brokers, and I believe this may be true for Century 21. It was at one point.

Mr. KONIGSBERG. It still is.

Chairman LAFALCE. What do you do when you want to put up a franchise operation in a local business district and there is a certain architectural face to that street, and the franchises typical architecture is just in absolute clash with the architecture, the design of the street. How do you accommodate that?

Mr. SIMON. Franchisors typically work ostensibly within local zoning regulation. I mean, there is a McDonalds in Williamsburg, Virginia. It doesn't have the tall arches and the like. It looks positively colonial. So this is something that is subject to local zoning law.

Chairman LAFALCE. We have a colonial McDonalds in my district too, in the town of Lewiston.

Mr. PURVIN. Golden columns instead of golden arches.

Chairman LAFALCE. Is this something that the franchisor has to agree to, as opposed to the franchisee? Who deals with the local community on this?

Mr. SIMON. It varies greatly. In certain systems, the franchisor owns the property, builds the unit and then leases it to the franchisee.

In other franchise systems, it is the franchisee who would seek out the site, get approval from the franchisor and then will build the unit. That franchisee might be given the plans that the franchisor uses, but the party building the structure and seeking the building permits, has to work within the local zoning law. In certain cases that will be the franchisee, in certain cases that will be the franchisor. It varies.

Chairman LAFALCE. I would imagine that his might be done internationally too, when you are trying to fit into a country, rather than superimposing everything about your franchise operation to that country.

I remember well over a decade ago when I went to Santiago, Chile, and saw a Burger King and it didn't fit. As far as I was concerned, it just didn't fit—not that Burger King didn't fit, but it stood out and not in a very pleasant way it seems to me.

It was an intruder in this commercial area, at least in my eyes. Maybe not in the eyes of others. It offended my aesthetics, but that was only mine. I don't know about the others.

Thank you very much. We will be talking more on this.

Mr. Conte has some questions he would like to submit for the record. Will the witnesses kindly agree to respond to those questions in writing for a part of that record?

[The questions referred to above may be found in the appendix.]

Chairman LAFALCE. Thank you very much.

The subcommittee is adjourned.

[Whereupon, at 12:15 p.m., the committee was adjourned subject to the call of the Chair.]

APPENDIX

STATEMENT OF REP. JOHN J. LaFALCE, CHAIRMAN
COMMITTEE ON SMALL BUSINESS

HEARING ON FRANCHISING IN THE U.S. ECONOMY

September 27, 1990

Franchising has swept across the American marketplace in the past decade changing the way Americans conduct business and purchase goods and services. It has been called the most dynamic business arrangement since the corporation and a "dominating force" in the U.S. economy.

Where once franchising was limited to automobile and gasoline dealers, hotels and fast food outlets, it has emerged in such diverse areas as financial services, electronics, health care, corporate services and even educational institutions. So pervasive is its influence throughout the economy that it has become increasingly difficult to purchase a product or service that is not affected by franchising in some manner.

Franchising's success derives not only from its adaptability to an expanding array of industries and markets, but also from the unique ability of franchise arrangements, when properly structured and implemented, to accommodate the diverse economic needs of key segments of the economy. For large companies and new businesses, franchising offers a systematic and cost-effective method for rapidly expanding marketing and distribution networks with a minimum of direct involvement and financial investment. For aspiring entrepreneurs, it provides an opportunity to own and operate a business involving a tested product or format with a minimum of financial risk. And for consumers, franchising provides a way to purchase known products and services in a consistent and reliable manner.

Franchising now accounts for a large segment of the nation's small businesses and plays a major role in new small business formation. The 27,000 new franchise outlets estimated to have been opened during 1988 represent the addition of a new small business every 20 minutes of every day throughout the year.

Some 3,000 U.S. companies currently operate franchise networks encompassing more than a half-million franchises across the nation. These franchises collectively employ more than 7.4 million American workers and account for more than $600 million in annual retail sales--roughly one-third of all retail sales of goods and services in our economy.

The same factors that have prompted franchising's success in this country are also at work around the world. In January we saw the opening of a McDonald's restaurant in Moscow; last week a Pizza Hut opened its doors in Beijing. These are the most visible examples of an increasing "internationalization" of franchising that is making American franchise trademarks, products and business operations familiar objects throughout the world. Foreign franchisors are also entering the U.S. market in increasing numbers, opening or acquiring sizeable franchise networks.

At a time when business journals and magazines are heralding the growing successes of franchising at home and abroad, I am troubled by the increasing number of reports that document serious and continuing problems. Recent press reports have reported, for example, growing numbers of fraudulent franchise arrangements; increasing incidence of franchise terminations related to corporate mergers and take-overs and to foreign acquisitions of franchising systems; rising numbers of law suits and class action suits by franchisees against franchise companies; and significant increases in arbitration proceedings to resolve disputes between franchisors and franchisees.

These reports suggest that there are significant problems in franchising that will only become more pronounced if the economy continues to weaken. These reports also raise serious questions as to the adequacy of current law and regulation for assuring proper structuring and operation of franchise systems and for protecting the interests and expectations of consumers.

Let me add that I am also disturbed by some apparent contradictions and inconsistencies that seem to pervade our entire discussion of franchising. For example,

--We currently have no federal law which broadly governs franchise sales or operations, and yet the FTC spent much of last year debating whether it should preempt all or part of the States' franchise laws.

--The Federal Government requires comprehensive disclosure of all aspects of a franchise opportunity to protect potential investors, yet no office or agency of the government even collects, let alone reviews, these disclosure documents.

--State regulators continue to advocate for stronger and more comprehensive state enforcement of franchising practices, but only a third of the states have bothered to provide for any form of broad franchise regulation.

--Franchisors argue that market forces will remedy serious inequities within franchise systems, but they impose contracts that are so restrictive that they effectively eliminate all elements of the market in the operation of their franchise systems.

These and other contradictions in franchising are troubling and suggest the need for broad national discussion of the purposes and problems of franchising, and of the role franchising should play in the nation's economy.

Unfortunately, such discussion has been hampered by a lack of comprehensive and accurate information about franchising nationally. Many of the figures I have cited are sophisticated "guesstimates" of national franchise growth and sales. There is currently no federal agency that collects even basic information about new franchise development and franchise sales. And we have virtually no basis for developing comprehensive national data on such things as franchise fraud, franchise failures and terminations, and franchise litigation. Such data is absolutely critical if we are to undertake any kind of responsible discussion of appropriate policy and regulation in this area.

The purpose of today's hearing is to begin a process of broad inquiry and discussion into franchising, and to document its growing significance in the nation's economy. At the same time, we want to begin to assess, in general terms, the adequacy of current laws and regulation governing the structuring, sale and operation of franchise arrangements. Two questions are important in this regard--Are current laws and procedures adequate to protect the interests of franchisors, franchisees and consumers? Are additional, or alternative structures or policies needed at either the state, national or international level?

I am increasingly interested in the international aspects of this question. As someone who has spent years promoting international trade and improvement in the competitive position of American business, I look to the movement of American franchisors abroad with both enthusiasm and concern. I sense that there are numerous obstacles to the expansion of franchises abroad which have yet to be addressed in any fashion in our nation's bilateral or multilateral trade negotiations. I hope that our discussion today will also begin to define the key issues of franchising that should be incorporated in future trade negotiations.

Today's panel offers a distinguished group of representatives of government and business organizations which have significant direct experience with franchising. Their interests and experience range from the broadest aspects of franchising internationally to the technical aspects of the contractual relationship between individual franchisors and franchisees.

Statement of the Honorable Joseph M. McDade
Vice Chairman
Committee on Small Business
U.S. House of Representatives
September 27, 1990

Mr. Chairman, I appreciate your convening this hearing today to address the issue of franchising. Today, franchising is a dynamic force in our economy, generating approximately one-third of our nation's total retail sales and employing nearly 8 million workers nationwide.

Ideally, franchising is a system that is of great benefit to all involved. For the business owner, including small business owners with insufficient expansion capital, franchising presents a systematic and cost-effective opportunity to achieve rapid expansion of a marketing system with minimal involvement and monetary commitment. For the prospective franchisees, this system limits financial risk associated with owning a business by giving entrepreneurs the opportunity to own and operate an established business with a tested product and marketing format. The consumer benefits from the convenience of purchasing familiar products and services in a known setting.

However, there have been some reports of entrepreneurs who have invested in franchises, only to lose their capital to fraudulent schemes. Today's testimony will present both sides of the issue of whether the business of franchising is properly regulated.

Franchising is expected to rapidly grow at home and abroad during the 1990's due to America's increasing shift to a service economy and the establishment of a free-market economy in Eastern Europe. In order to guarantee this growth, it is clear to me that those individuals wishing to start out in the business world through franchising must be assured that an investment in a franchise is a sound and legitimate one. Franchising, which has been called "the dominating force" in the distribution of goods and services, must continue to grow and present entrepenuers with the opportunity to make solid investments in their future as well as the future of our nation's economy.

SILVIO O. CONTE
First District, Massachusetts

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Statement of the
Honorable Silvio O. Conte
Hearing on Franchising

September 27, 1990

Thank you Mr. Chairman. I want to commend you for holding this hearing. I agree that franchising is an area of great importance to this committee.

Franchising has grown into a $678 billion dollar industry involved in almost every conceivable business. It employs nearly 8 million people, many of them in small businesses. In many ways franchising is the embodiment of the American dream; it's hard-working people who own their own businesses.

Unfortunately, franchising also attracts its share of unscrupulous people. In addition, franchising agreements often appear hopelessly complicated, even unfair. Those factors, combined with inconsistent state and federal regulations, point to problems in franchising's future.

It may be time for reform. However, we must protect the creativity and economic vigor of the franchising industry. We must keep the people with dreams from having their dreams stolen, but we should take care not to smother anyone's entrepeneurial spirit with our concern.

I am glad to have this opportunity to examine franchising more closely and I look forward to the testimony of our panel of expert witnesses. Thank you.

MATERIAL SUBMITTED AS BACKGROUND FOR THE TESTIMONY OF

ALEX S. KONIGSBERG

HEARING ON FRANCHISING IN THE U.S. ECONOMY

September 27, 1990

THE IMPACT OF FRANCHISING ON THE ECONOMIES OF CERTAIN COUNTRIES**

Franchising has been a dynamic force in the economies of many countries for over thirty-five years. Once mostly limited to fast-food restaurants and hotels, franchising has diversified into virtually every domain of business and has helped re-shape consumer habits and expectations throughout North America, in many countries of western Europe, Australia and Japan. Moreover, with the movement towards a global economy and the growing expenditures on services in many developed economies, the rate of growth of franchising as a method of doing business is likely to accelerate.[1].

In response to the early fears and biases relating to franchising, some countries elected to enact specific legislation to regulate franchise activities.[2] More often, though, the legislators opted for a more passive role relying on existing legislation as it effects commercial transactions in general and to some extent on the different associations of franchisors to police the practices of its members.[3]

No doubt franchising has achieved "big business" proportions. It is not, however, "big business" in the traditional economic sense of implicating huge economies of scale or uplifting barriers for entry into the market.

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1. International Franchise Association, A Comparison of International -vs- Domestic Expansion by U.S. Franchise Systems by Bruce J. Walker, June 1989, page 2. A copy of this study is reproduced as an appendix to this book with the kind permission of the International Franchise Association.

2. The topic of the impact of legislation on franchising is the focus of Chapter III.

3. The different associations of franchisors are listed in an appendix to this book.

**A Chapter contained in a book entitled *International Franchising*, authored by A.S. Konigsberg, to be published by Transnational Juris Publications, Inc.

Franchising generally fosters competition and encourages creativity, specialization and the opening up of new forms of distribution. While statistics in many countries reveal the imposing monetary figures directly associated with franchise operations, it should be noted that the role of the independent entrepreneur is really the heart and soul of franchising. Governments have long begun to recognize the importance of encouraging the development and growth of small business, and franchising has proven to bear an unending capacity to contribute to this end.

The economic benefits of franchising have also become the focus of increasing attention. This chapter explores the extent to which franchising has developed in several countries, the degree to which such development has been induced by domestic or foreign concerns, and the impact franchising has had on the general economies of such countries.

It will become evident that the state of franchising has matured much more quickly in some countries than in others. Perhaps symptomatic of the lesser developed franchise markets is the paucity of available statistics on the role franchising plays in the economies of such countries. Also problematic to the undertaking of a comparative analysis is the lack of uniformity in the definition of franchising. Some countries, for example, may include in their franchising statistics a wide range of industries loosely identified with franchising such as distributorships, dealership arrangements, licensing arrangements and co-operatives. Other countries will only include statistics from business format franchising, while others provide separate statistics for the different types of franchises. The discrepancies can be misleading and comparisons must accordingly be tempered with prudence.

I. THE UNITED STATES OF AMERICA

Nowhere is franchising more prevalent than in the United States. As confirmed by the U.S. Department of Commerce in a recent study, "almost every town in America claims at least one franchised restaurant along its main street."[4] U.S. franchisors now operate in other countries in numbers so large that if their foreign outlets became one separate domestic system, they would be formidable competitors at home.[5]

A quick perusal of the current statistics depicts the magnitude of the impact which franchising has on the American economy:

(i) Franchise outlets directly employed approximately 7.7 million people in 1988 and this number is expected to increase to 8.3 million in 1990.[6]

(ii) The amount of sales of goods and services from franchise outlets in the United States is expected to reach $716.7 billion in 1990 with 533,000 outlets.[7] These numbers indicate an increase since 1980 of nearly 21% in the number of outlets and 215% in the sales volume from franchise outlets.

(iii) In 1990, retail sales by franchise outlets represented 34% of all retail sales in the United States.[8] Moreover, the most recent forecasts indicate that this percentage is expected to increase

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4. International Franchise Association, "The Future of Franchising: Looking 25 Years Ahead to the Year 2010", by The Naisbitt Group, Washington, D.C., (1985), page 1.

5. Philip F. Zeidman, "Have Franchise, Will Travel: International Franchise 1987" (1987) 93 Business Franchise Guide, page 1.

6. International Franchise Association Educational Foundation, Inc., Franchising in the Economy: 1988-1990, Horwath International, (Washington, D.C., 1990), page 1.

7. Ibid, page 1.

8. Ibid, page 11.

dramatically for the balance of the decade.[9] According to a 1985 study by The Naisbitt Group:

> Most industry experts believe that sales by business format franchises will reach $438 billion (U.S.) by 1995 and $705 billion (U.S.) in the year 2000. By 2005, sales should be at $1 trillion (U.S.), rising to $1.3 trillion (U.S.) by the year 2010. If traditionally non-franchised businesses, such as banking, become accepted as franchised operations, these numbers could be much higher.[10]

Reasons often suggested for the continued increases in the growth of franchising in the American economy are rising personal income, stable prices, high levels of consumer optimism, and increased competition for market share. According to the U.S. Department of Commerce:

> a slowly growing U.S. population, shifting demographic patterns and the use of new technology have intensified competition among franchising companies. These factors have increased the number of mergers and acquisitions in the franchising system, and it is expected that this will persist during the next five years.[11]

Another very important contributing factor is the attraction of foreign firms to the United States. Specifically, Canadian, European and Japanese franchisors are entering the United States market with franchise systems which have already been developed in those countries. In 1988, it was estimated that as many as 60 foreign franchisors were operating in the United States.[12]

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9. Ibid, page 11.

10. The Naisbitt Group, supra, note 4, page 27.

11. U.S. Department of Commerce, International Trade Administration Office of Service Industries, Franchising in the Economy: 1986-1988 by Andrew Kostecka (Washington, D.C.: U.S. Government Printing Office, 1988), page 6.

12. Walker, supra, note 1, page 2.

American franchisors have found similar success in foreign countries. Since 1971, the number of U.S. franchisors with operations in foreign countries has nearly tripled. In 1988, there were 374 American business format franchisors operating in foreign countries with more than 35,000 outlets;[13] and, according to the study by Walker on behalf of the International Franchise Association,[14] it appears likely that that number will grow considerably. The study found that nearly 225 American franchisors indicated a desire to expand outside the United States. It further revealed that 93% of franchisors who have already done so have similarly intimated an intention to increase their presence in foreign countries.

In 1989, it was estimated that 19.9% of all U.S. franchisors have foreign franchises,[15] but the scope of these international operations is still relatively of little account. For example, nearly two thirds of American based franchisors who have franchise outlets outside the U.S. have less than 25 outlets.

In the United States, statistics have been compiled to include two main forms of franchising:

(i) product and trade name franchising which include bottling companies, automobile dealerships and gasoline service stations and,

(ii) business format franchising.

In 1990, it is expected that of the forecasted 533,000 total franchise outlets, there will be close to 393,000 (nearly 75%) business format franchise outlets.[16] Restaurants represent the largest category among the various categories of business format franchises in terms of both number of franchise outlets (102,135) and sales revenue ($76.5 billion). Gasoline service stations is the largest single class of product and trade name franchises with an expected 111,700 outlets in 1990.[17] Sales by business format franchises in 1990 is expected to surpass the 1989 figures by 10%. This increase is greater than both the expected growth of the Gross National Product(2%) and of the Consumer Price Index(4.1%).[18]

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[13] U.S. Department of Commerce, supra, note 11, page 1.

[14] Walker, supra, note 1, page 17.

[15] Ibid, page 3.

In another study, undertaken by The Naisbitt Group, although more dated, the results imply a more conservative forecast for franchising in general:

> Revenues from product and trade name franchising, which is conducted by relatively few businesses, have been declining. The number of individual product and trade name franchise operations, which include automobile dealers, gasoline service stations, and soft-drink bottlers, has declined by 40% since 1973.
>
> Sale of goods and services by product and trade name franchisors will continue to fall. Annual growth rates have slowed from 12% during 1972 and 1978 to 8.5% during the 1979 to 1985 period. Sales by product and trade name franchisors are expected to slow further, to an annual growth rate of approximately 5% in 1990.
>
> By far the fastest form of franchising is business format franchising. The number of business format franchisors stood at 909 in 1972 and has doubled since then. The average annual growth rate of business format franchises is 15% during the 1972 to 1978 period, and should remain at its 1979 to 1985 rate of 11.5% for the next five years.

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[16] U.S. Department of Commerce, supra, note 11, page 5.

[17] Ibid, page 5.

[18] Ibid, page 10.

> The boom in format franchising is a result of mainly two trends emerging simultaneously. The first is the shift in the U.S. economy from the production of goods to the providing of services. This has created an environment that encourages service franchises, especially those that correspond with current life-styles. In particular, services that fill the needs of working women have been translated easily into the franchising format. Second, more people, especially minorities and women, have discovered that format franchising offers them the opportunity to be entrepreneurs without the risk usually associated with starting a business. The force drawing scores of potential business people to franchising is the proven franchise format itself, which enables franchisees to buy knowledge from the parent company. Since franchisors have a formula in place, franchisees can move into the mainstream with far less capital than they would need for an independent operation."[19]

The same study predicts that the growth rate of overall franchising sales in the U.S. could begin to slow down as the marketing scheme becomes more prevalent in a wide range of business areas and thereby saturates some markets. Franchising growth then will begin to parallel growth in the service economy.[20]

II. CANADA

Like so many other sectors of its economy, the Canadian franchising market has in many ways mirrored the evolution of franchising in the U.S. . While the aggregate figures are indicative of a significantly scaled-down franchising system in comparison with that of the U.S., the numbers rate very favorably as a percentage of population, Gross National Product and total retail sales.

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19. The Naisbitt Group, supra, note 4, page 2.

20. Ibid, page 27.

In 1984, retail sales from franchise outlets in Canada exceeded $48 billion (CDN) or approximately 45% of total Canadian retail sales.[21] During 1985, the Canadian Franchisors Association estimated that over 50% of these sales were generated from business format and other "non-traditional" forms of franchising.[22]

Between 1981 and 1984, franchising in Canada averaged annual sales increases of 15%. During the same period, total Canadian retail sales and Gross National Product increased annually by only 8% and 7% respectively.[23]

In 1987, approximately 1,000 franchisors located across Canada and operating nearly 45,000 franchise outlets accounted for sales totalling $61 billion (CDN). The annual growth rate of Canadian franchising sales was 20% in 1985, 25% in 1986, and was projected to be 40% for the period 1988-1992.[24]

According to a study published by the Department of Industry, Trade and Commerce of the Government of Canada, nearly half of the business format franchises in Canada were owned by foreign companies, with the vast majority of such companies from the U.S. . Perhaps due to its geographical proximity

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21. Franchising: The current Situation, Canadian Franchisors Association, Toronto, Ontario, 1985.

22. The ratio of business format franchising sales to total franchising sales has been steadily increasing over the last decade. In 1977, sales through business format franchising, expressed as a percentage of all Canadian franchised sales, was only 25%. See "Franchising in the Canadian Economy, 1976-1981".

23. Arthur Trebilcock, Bringing Your Franchise to Canada: Regulation of Selling Practices and the Use of Disclosure Documents (unpublished), (1988).

24. Salon International de la Franchise, Paper by Arthur Trebilcock, Paris, France, (1989), page 24.

and cultural similarities, Canada is seemingly the natural market for American franchise expansion.

The U.S. Department of Commerce indicated that in 1986, 29% of all U.S. foreign franchise outlets were located in Canada with a total of 237 U.S. franchisors operating 9,031 establishments.[25] This translates into approximately 40% of all U.S. foreign franchise outlets being located in Canada. Franchisors from other countries, primarily France, Australia and Great Britain, are also entering Canada at an accelerated pace.

Of those franchises that are indigenous to Canada, at least 25 have begun testing the markets abroad. A 1987 survey conducted by the Canadian Franchisors Association found that over 40% of the Canadian franchisors who responded planned to expand outside Canadian borders, with the United States being the most popular choice and the United Kingdom following as second choice.[26]

III. FRANCE

It has often been said that France is the heart and soul of European franchising. In 1971, the Centre d'Etude de la Commercialisation et de la Distribution (CECOD) recorded 34 franchise chains in France.[27] By 1977, this number grew to 108 with as many as 7,500 franchise outlets. At last report, in 1988 there were approximately 675 franchisors with nearly 30,000

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25. Canadian Franchisors Association, supra, note 21.

26. "Franchising Facts Canada 1988", Canadian Franchisors Association and The Royal Bank of Canada, page 24. According to the survey, the respondents represent 25% of the business format franchise community as of December 1987.

27. The statistics regarding French franchising were taken from "Franchising in the European Community", 1989, A report by Chater Associates: Management Consultants, page 18. Note that these figures exclude sales of automobiles and trucks, gasoline and soft drinks.

franchise outlets.[28] The statistics also reveal that in France franchising is responsible for the employment of nearly 150,000 people. Sales generated by franchising in 1988 exceeded $16 billion (U.S.), or approximately 5% of the total retail sales in France.

Unlike some of its neighbors, France is characterized by a predominance of large, indigenous franchise operations. Only 5% of the outlets represent foreign franchisors. With 25% of the franchising market, the clothing and footwear franchises account for much of the expansion in retail franchising. Food-stuffs and furniture and home equipment are similarly large sectors with 15% and 20% of total franchising sales respectively. The remaining 40% of the market includes: service franchises at 25.5%, the building sector at 7.5% and hotels and restaurants at 7%.

IV. UNITED KINGDOM

Although the practice of franchising is not a new phenomenon in the U.K., it has not experienced the same explosive growth as the countries discussed above. One often suggested reason for this slower development is that early on, the pyramid selling schemes and other fraudulent practices became associated with franchising and gave it a bad reputation.[29] However, since the establishment of the British Franchise Association (BFA) in 1977, the situation has improved considerably; the U.K. franchise market is now solidly based and is viewed favourably by government, media and the public as a whole.

The most recent available statistics reveal that in 1988 there were 270 franchisors in the U.K. with 20,000 outlets. The overall sales figure from franchise outlets for the same period was $6.1 billion (U.S.). Only

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28. The CECOD estimates a continued even growth phase with an anticipated future expansion rate of around 6% per annum.

29. "Franchising in the U.K.: The Business, Taxation and Legal implications", by Adlers and Arthur Young, (1987), page 7.

four years prior there were less than 8,000 outlets with sales totalling less than $1.5 billion (U.S.).[30]

In a report prepared by Power Associates for the BFA and sponsored by National Westminster Bank plc, it was found that most British franchisors began doing business after 1982. The largest sector of the British franchise market, in terms of sales figures, was identified as home improvements and maintenance fixtures and furnishings; leisure products and services was second and fast food was third. In terms of number of outlets, the fast food restaurants are at the forefront with 1,898 outlets. The home improvements and maintenance sector had 956 outlets.

Unlike continental Europe, master franchising in the U.K. is well developed and, consequently, there is a strong presence of American franchises operated by sub-franchisors. The actual number of American franchisors in the U.K. however, - reported to be 74 in 1986[31] - is low in comparison to those that are home produced.

Service franchising dominates the U.K. market and, as in the United States, has led to some of the most original and innovative concepts in Europe, such as carpet cleaning, will drafting, children's play centres and domestic help services.[32]

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30. Ibid, page 9. Note that these figures do not account for sales of automobiles and trucks, gasoline and soft drinks.

31. U.S. Department of Commerce, supra, note 11, page 10.

32. Chater Associatets, supra, note 27, page 6.

V. JAPAN

Not uncharacteristic of the Japanese economy, franchising in Japan has expanded at a very impressive rate. There were just two franchisors in Japan in 1963. Only 15 years later, this number climbed to 350.[33]

The most recent data estimates that as of 1988 there were 700 franchisors doing business in Japan operating 102,397 outlets and producing an aggregate sales revenue of approximately $44.3 billion (U.S.).[34]

Generally, there are three main categories of Japanese franchises: product distribution, food service and service related business.[35] In 1988, approximately 200 of the 700 franchisors were engaged in service related businesses, another 200 were involved in product distribution, and the balance were in the food service business.[36]

Despite the fast-paced growth of the Japanese franchise market, it appears far from reaching its saturation point. In 1987, franchising accounted for only 3.7% of total retail sales in Japan compared with a figure of 33% in the United States for the same period.[37]

Japan has proven very attractive to American franchisors in their quests for international expansion. According to the U.S. Department of Commerce, Japan has become the second largest foreign market for American franchisors. In 1986, a total of 69 U.S. based franchisors comprising 7,366 outlets were operating in Japan, of which 72% were of the food service category.[38]

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[33] Salon International de la Franchise, Paper by Mitsuo Fuse and Raisuke Matsuzaki, Paris, France, (1989), page 96.

[34] Martin Mendelsohn, Franchising in the World Today, (Unpublished), (1989), page 14.

[35] Mitsuo Fuse and Raisuke Matsuzaki, supra, note 33, page 96.

[36] Ibid, page 96.

[37] Ibid, page 96.

VI. WEST GERMANY

It was not until the 1960's that franchising as a way of doing business began to attract attention in West Germany. There were only a dozen franchisors in West Germany before such time.[39] By 1972, this number grew to 60 and, at last count, 180 franchisors with approximately 9,000 outlets existed in 1986. Moreover, a recent forecast estimates a continued growth at an accelerated rate.[40]

Two reasons have been suggested for the slower development of the West German franchise market relative to some other countries. Firstly, because the retail section - which includes 70% of West German franchising - is characterized by a high level of price competitiveness and exceptionally demanding consumer expectations for high quality goods, market entry is often a difficult task. The second reason relates to the inherently organized and integrated nature of West Germany's retailing sector. Since it is not uncommon for West German retailers to buy in bulk on a cooperative basis, the need to franchise is not as apparent.[41]

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38. Ibid, page 96.

39. Salon International de la Franchise, Paper by Hans Lang and Manfred Strauch, Franchising in Germany: How to be Successful, Paris, France, (1989), page 3. Note that these figures do not include sales of vehicles, soft draft bottles and hotels (concessions). The German Franchise Association is currently collaborating with the University of Hamburg to institute a survey of the total number of franchises including the above variety.

40. Ibid, page 4. It was estimated that in 1990 there will be as much as 400 franchisors and 20,000 outlets established in West Germany.

41. Chater Associates, supra, note 27, page 4.

VII. ITALY

In 1988, Italy was home to nearly 200 franchisors having a total of approximately 11,500 franchise outlets in operation.[42] During the same period, the gross sales by these outlets exceeded $3.3 billion (U.S.). The Italian franchising market consists of a balanced distribution of both foreign and domestic franchisors who are primarily focusing their efforts in retail product distribution.

VIII. NETHERLANDS

Franchising has proven to be a dynamic force in the Netherlands during the past few years.[43] In 1987, 244 franchisors having a total of 8,252 outlets were located in the Netherlands, and the aggregate franchising sales revenue that year was in the range of $5.8 billion (U.S.).[44] The leading form of franchising in the Netherlands is product distribution with service sector franchises following second in popularity.

While there is a growing presence of foreign based franchises in the Netherlands, the market remains dominated by indigenous franchise operations.

IX. SPAIN

Although franchising is essentially a novel method of doing business in Spain, it is undergoing a period of "striking development".[45] It was not until Spain joined the European Economic Community that the practice of franchising began to increase in popularity. Today, as a result of the importing of numerous foreign chains — both European and American — Spain's franchise market is experiencing the fastest growth rate in Europe.[46]

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[42] Ibid, page 3.

[43] Ibid, page 5.

[44] Ibid, page 3.

[45] Enrique Climente, "Franchising in Spain, 1987: Legal and Business Developments". Paper presented in London at the International Bar Association meeting.

The breadth of the Spanish franchise market consists of retail product distribution with a particular emphasis on clothing and food stuffs. The service sector of the franchise market is still very much in its infancy and remains virtually undeveloped.[47] With many Spanish regions providing valuable financial incentives to a wide range of businesses, the market for franchising is very promising for both national and foreign franchise operations.

X. BELGIUM

Franchising has been an accepted method of doing business in Belgium for over 50 years. As of 1989, 77 business format franchisors with 4,045 outlets were located in this relatively small nation, with an overall sales revenue of $3.2 billion (U.S.).[48] Retailing, especially those firms engaged in product franchising, dominates the Belgian franchise market.

XI. CONCLUSION

As can be seen from the foregoing, franchising has assumed a formidable role in the economies of many countries and, if the statistics are any indication, the presence of franchising shall continue to grow both domestically and internationally.

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[46] Chater and Associates, supra, note 27, page 5.

[47] Ibid, page 5.

[48] Ibid, page 3.

A chapter contained in a book entitled "International Franchising" authored by A.S. Konigsberg to be published by Transnational Juris Publications, Inc.

LEGISLATION IMPACTING ON FRANCHISING

Success in international franchising depends on a clear understanding of each target market. This includes not only an understanding of the tastes, buying habits and culture of the consumer, but also a fundamental insight into and an understanding of the laws and commercial practices which may impact on the particular method of business which is being considered. A careful consideration of foreign laws, regulations and practices serves three essential purposes. First of all, it is the basis upon which to evaluate the viability of franchising in a particular country. Secondly, when franchising is appropriate, it will influence the choice of commercial vehicle available to the franchisor to export his franchise system and thirdly, tne franchise agreement must be prepared to accommodate the legal environment in which the foreign franchise must operate.

The legal environment in which a franchise can be established in a foreign country varies from country to country. Although legislation that relates directly to the offer of sale or the sale of a franchise only exists in the United States of America and the Province of Alberta in Canada, this situation is subject to change. Other countries have, in the past, introduced, legislation regulating the sale of a franchise but, for one reason or another, have changed their minds. As a result such legislation has not come into effect. An example of countries which have introduced legislation but have not followed through with such legislation, include Australia,[1] Sweden[2] and the Province of Quebec[3] in Canada. In addition, the Government of Brazil in

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[1] In 1986, the Ministerial Counsel for Companies and Securities in Australia introduced legislation which would have affected to a significant extent the manner in which franchisors carry on business in Australia. Subsequently, a second draft of the bill was introduced which contained disclosure requirements similar to those which exist in the United States, as well as other matters including criminal sanctions for certain defined activities, accorded remedies to franchisees, etc. The bill was subsequently abandoned after representations were made to the Australian Parliament by interested franchise associations which concluded that (i) there was no consensus that such legislation was ever required and (ii) existing legislation, if properly enforced, was sufficient to prevent fraudulent practices occurring within the franchising industry. On September 1st, 1987, in order to avoid uncertainty as to whether or not a franchise constituted a "security", regulations were adopted exempting franchising from the application of the Australian Companies Code and the Securities Code. As a result of those regulations, franchisors were not required to comply with the National Companies and Securities Commission guidelines or to satisfy exemption guidelines. For a further elaboration of this subject, see the Chapter on Australia which appears in the Survey of Foreign Laws and Regulations Affecting International Franchising, supra, Chapter I, note 3.

[2] In 1987, a Swedish parliamentary commission published a report recommending that legislation specifically relating to franchising be adopted. Such proposed legislation would have the effect, inter alia, of forcing a franchisor to negotiate with employees of his franchisees prior to making any changes to the franchise system which would affect employees of the franchisee. However, such proposals appear to have been abandoned. For a further discussion of this subject, see the Chapter on Sweden which appears in the Survey of Foreign Laws and Regulations Affecting International Franchising, supra, Chapter I, note 3.

[3] In 1979, the Province of Quebec introduced legislation to amend its Securities Act so as to include a franchise within the definition of a security. Regulations were never issued and subsequently the Quebec Government re-amended the Securities Act so as to delete the word "franchise" from the definition of a security.

May, 1989, introduced a draft Bill of Law to the Brazilian House of Representatives which, if enacted, will impact heavily on the way franchising will be carried on in that country.[4] Finally, on December 31st, 1989, the French Government adopted statute number 89-1008, which will impact on the manner in which franchises are offered for sale and sold throughout France. Although published on January 2nd, 1990, this statute will only come into effect following publication of a further decree, known as the "décret d'application".

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[4] "Projet de Loi" 1526, of 1989. The future of this legislation is today uncertain.

The French statute has general application to many businesses; however, Article 1[5], while never specifically using the word "franchise", will have a very direct and powerful impact on the franchising industry in France, as for all relevant purposes it constitutes disclosure legislation. It is clear from the legislation that any franchisor wishing to franchise in France will be required to provide a document to prospective franchisees containing information on the background and business experience of the franchisor. In addition, such document must contain a description of the essential elements of the agreement including, the term of the agreement, provisions relating to its renewal, reasons for termination as well as the conditions under which the agreement may be assigned to a third party. Furthermore, to the extent that the franchisor uses a traditional form of application for a franchise which requires the payment of a sum of money by a prospective franchisee, the provisions of the law require that the franchise agreement, as well as the disclosure document referred to above, must be provided to the prospective franchisee, at least twenty (20) days prior to the required payment.

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[5] The following is an unofficial translation of Article 1:

> Any person who grants to another person a right to use a trade name, trade mark or logo, while requiring from such other person an exclusive or quasi exclusive undertaking in connection with the exercise of its activities, shall, prior to the execution of any agreement in the common interest of both parties, provide to the other party a document giving such sincere information as would permit the other party to make an informed decision.
>
> Such document, the contents of which shall be determined by decree (to be issued by the Government), shall specify, among other things, the experience and the length of time the business has been carried on, the present state of the relevant market and its growth potential, the size of the network of users, the terms and conditions of such agreement with respect to the term, renewal, termination and assignment thereof and the extent of such exclusive rights.
>
> Whenever payment of any sum of money is required prior to the execution of the aforesaid agreement, and particularly in order to reserve a territory, the undertakings made in consideration of such payment as well as the reciprocal obligations of the parties in the event of default must be stated in writing.
>
> The document contemplated by the first paragraph as well as the proposed agreement, shall be delivered at least twenty (20) days prior to the earlier of the execution of such agreement or payment of the sum of money described in the previous paragraph.

Although it is literally impossible for anyone to become familiar with the laws which effect franchising in general, the franchisor must nevertheless be aware of the existence of such laws and the way they can generally impact on their decision to franchise on an international basis.[6]

Apart from legislation which deals specifically with franchising, there is often legislation which, while not aimed specifically at franchising, significantly affects the franchise industry, and must be taken into account by a franchisor who wishes to export his franchise system to a particular country. This Chapter deals briefly and in a cursory manner with franchise legislation in the United States of America and in the Province of Alberta in Canada. In addition, a sample of national laws which directly effects franchising and which must be consulted when

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6. The list of questions appearing in the appendix provides a good example of the types of questions that the franchisor must put to local counsel so as to develop an appreciation of the legal environment existing in a particular country that will effect the establishment and operations of his franchise system in that country.

conducting a legal audit for a given foreign country, will be examined.

I. SPECIFIC FRANCHISE LEGISLATION

(1) UNITED STATES:

The United States, with its federal and state system, has both federal and state laws which directly regulate franchising. These laws relate to the manner in which a franchise may be offered and sold as well as the manner in which a franchisor may deal with his franchisees. There are disclosure requirements, registration requirements, and some limitations placed on the rights of franchisors to terminate, to refuse a transfer of or renewal of the franchise agreement. Some state laws also require that advertising materials be filed with the state before they may be used.

At the state level, fifteen state legislatures[7] have enacted franchise laws requiring the delivery of franchise disclosure documents to prospective franchisees prior to the making of an offer to sell or the actual sale of a franchise. These laws have as their basic tenet that franchisors must make full pre-sale disclosure in the form of a prescribed offering circular to prospective franchisees concerning the material aspects of the franchise relationship. This includes, for example, information relating to the history and background of the franchisor and the individuals associated with it, the nature of the franchise, and the proposed terms of the franchise relationship.

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[7] The fifteen states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

Thirteen of the fifteen states[8] require registration of the franchise or the franchisor, as well as the state's review of the offering circular. In these states, there are regulations providing that no sales activity may take place in the particular state before the franchisor has filed, and had approved, his offering circular with the appropriate state agency. Because state registration laws are only concerned with the degree of disclosure, the fairness or equity of the offering is not scrutinized at this stage.

Application for registration of a franchise is made to the relevant state franchise administrator who reviews the application materials and, to the extent that they are satisfactory, will issue an order of registration. In addition to the offering circular, the franchisor must include in his application, the prescribed form of application and ancillary documents, a copy of the standard franchise agreement, any other agreement that the franchisor intends to use in connection with his franchise, the franchisor's audited balance sheet for the immediately preceding fiscal year, audited profit and loss statements for each of the three preceding fiscal years as well as such other financial information as is necessary to provide a financial picture of the franchise not more than ninety days prior to the filing of the application for registration. The timing requirements for delivery of the offering circular to franchisees vary from state to state, but in most cases, state timing requirements are pre-empted by the Federal Trade Commission Rule's (the "FTC Rule") timing requirements which will be discussed below.

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[8] The states of Michigan and Oregon are the two exceptions, where only a notice of intent to commence sales need be filed.

In addition, each of the states requiring franchise presale disclosure permits the use of a uniform disclosure format developed by the North American Securities Administration Association, known as the Uniform Application and Uniform Franchise Offering Circular ("UFOC"). The Uniform Application consists of an application for registration, consent to service and process as well as a salesman's disclosure form. Generally, the UFOC requires comprehensive disclosure regarding the franchisor and his predecessors and, to the extent that the franchisor is a corporation, such disclosure will apply to its officers, directors, managers and salesmen. In addition, information must be provided regarding the franchise being offered for sale, the terms of the franchise relationship, projections of actual or average results of operation of franchisee and/or franchisor owned outlets (provided that the franchisor elects to make such projections) as well as financial statements of the franchisor or its parent. The guidelines which form part of the UFOC contain a section which deals with state differences and which describes each aspect of the registration disclosure requirements of each state which are not the same in all states.

At the federal level, the Federal Trade Commission adopted the so-called FTC Rule on franchising entitled Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures which came into effect on October 4, 1979.[9]

The Rule requires franchisors to furnish prospective franchisees in every state with a detailed disclosure document which contains about twenty categories of information, including information relating to the franchisor, his business and the terms of the franchise agreement.

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[9] 16 CFR # 436.

The Federal Trade Commission does not review or require filing of the disclosure document, although it can take enforcement action against franchisors for failure to make disclosure or for providing incorrect or misleading information to franchisees. The disclosure document must be delivered to the prospective franchisee at the earlier of the first "personal meeting" for the purpose of discussing the franchise sale, or 10 business days prior to the earlier of the execution of the franchise agreement by a prospective franchisee or the payment of any consideration by the prospective franchisee in connection with the purchase of the franchise. In addition, a copy of each franchise document, in the form in which it is intended to be executed, must be given to the prospective franchisee at least five business days prior to the date the document is actually executed.

It should be noted that the FTC Rule applies to the sale of a franchise in all states of the United States. In addition, the FTC Rule does not require registration of documents, nor does it regulate the substantive aspects of the franchise relationship, but rather is designed to establish minimum standards for disclosure.

The FTC Rule does not affect state regulation covering the sale of franchises except to the extent that such state regulation offers lesser protection than the provisions of the Rule.

As an alternative to the disclosure format prescribed by the FTC Rule, the Federal Trade Commission permits the use of the 1986 UFOC format as an alternative disclosure format, provided that the FTC cover page is used and certain other conditions are followed. Thus, a franchisor may use either the UFOC disclosure format or the disclosure format set forth in the Rule.[10] However, very few franchisors will use the FTC format, given that it is not permitted in some states.

The Federal Trade Commission has recently issued a proposal the effect of which would be to pre-empt state franchise registration with the view to ending the dual disclosure / registration requirements that have characterized the franchise industry. Since it is evident that state franchise registration laws are in several instances more rigorous than the federal standards, the change could potentially result in franchisees being furnished with less information than that which is presently required under existing state legislation.

Apart from the disclosure and registration requirements, nineteen state legislatures have enacted laws which regulate the franchisor/franchisee relationship. These laws tend to vary from state to state but were all enacted in response to a perceived disparity in the bargaining power between franchisors and franchisees, and were intended to deal with specific aspects of the franchise agreement most susceptible to abuse by the franchisor. Such aspects include the conditions under which a franchisor may terminate the franchise agreement, refuse to consent to a proposed transfer of the franchise by the franchisee, refuse to renew the agreement, the infringement by a franchisor on the market of an existing franchisee, discriminatory treatment of a franchisee as regards the different fees charged to franchisees and other similar matters.

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[10] For a further elaboration of these matters, see the Chapter on the United States of America which appears in the Survey of Foreign Laws and Regulations Affecting International Franchising, supra, Chapter I, note 3.

Finally, most states have enacted anti-fraud legislation (popularly known as "state baby FTC laws") making it unlawful to engage in various unfair or deceptive acts or practices in connection with franchising.

(2) CANADA:

In Canada, unlike the United States, there is no federal legislation uniquely directed to the franchise industry, and, of the ten provinces, only Alberta has thus far, enacted a specific franchise law.

The Franchises Act (Alberta)[11] contains provisions requiring both registration and disclosure, in the form of a prospectus, by franchisors prior to any offer to sell or sale of a franchise unless an exemption from the provisions of the statute is available to the franchisor. The prospectus must provide full, plain and true disclosure of all material facts relating to the franchise being offered and both the form of application for registration as well as the prospectus must contain a certificate to that effect. The Chief of the Alberta Securities Commission Agency is given a broad discretionary power in considering an application for registration of a franchise prospectus.

The Act provides that a "trade" in a franchise in Alberta cannot take place until the franchisor has filed with the Chief of the Alberta Securities Commission Agency an application for registration in prescribed form as well as a prospectus. The registration of a franchise offering is valid for one year from the date of registration, but may be renewed for further one year periods by filing a registration renewal statement at least thirty business days prior to the expiration of the registration.

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[11] Revised Statutes of Alberta (1980, C.F. - 17), as amended.

The application for registration requires disclosure of prescribed information. In addition to such information, the prospectus must make full, plain and true disclosure of all other material matters relating to the franchise opportunity and must also include a comparative audited balance sheet for the prior two fiscal years of the franchisor, an audited statement of profit and loss for each of the franchisor's last three fiscal years, an audited statement of source and application of funds for each of the franchisor's last three fiscal years and an unaudited balance sheet and statement of profit and loss, together with an auditor's comfort letter, where the required audited statements referred to a period which ended more than ninety days prior to the filing of the application.

Franchisors may obtain an exemption from registration if they meet the requirements set forth in the Act relating to their financial requirements and business experience.[12] An exemption is also available at the discretion of the Chief of the Securities Commission Agency, if he is satisfied that it is in the public's interest to grant the exemption.

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[12] For a further elaboration of these matters, see the Chapter on Canada which appears in the Survey of Foreign Laws and Regulations Affecting International Franchising, *supra*, Chapter I, note 3.

II. ANTI-TRUST OR COMPETITION LEGISLATION

Franchise contracts typically provide for a wide range of covenants which by their nature can be viewed as being anti-competitive or which serve to lessen competition and may, depending on the jurisdiction, constitute illegal restraints of trade or as unduly restricting competition. Such covenants, which may be found in many franchise agreements include tied selling, price fixing arrangements, re-sale price maintenance, market and customer restriction, exclusive dealing and other similar controls.

Although these laws are not specifically directed at the franchisor/franchisee relationship they, for obvious reasons, often impact upon franchising, and accordingly, must be carefully examined before finalizing the franchise agreement.

III. SECURITIES LEGISLATION

Several countries, while without laws focused exclusively on franchising, have securities laws which may require treatment of franchise transactions as securities. This could result in the offer and sale of a franchise being treated as a security thereby subjecting the franchisor to registration and disclosure requirements, broker/dealer registration, having to maintain minimum capital requirements, anti-fraud provisions as well as any applicable criminal and civil liability remedies.

IV. INTELLECTUAL PROPERTY LEGISLATION

The issue of trade marks will be dealt with extensively in Chapter XIII. However, in addition to trade marks, it should be noted that protection of copyright is also available in many countries and can be a source of protection for the franchisor's manuals, publicity and promotional material, design of premises, etc. Copyright protection, as well as the scope of such protection, varies from country to country. Some copyright laws provide for protection of copyright by means of registration while others afford the same protection without any formality.

Similarly, laws relating to the protection of trade secrets and know-how or confidentiality provisions vary from country to country. Moreover, in certain countries provisions contained in a franchise agreement requiring the franchisee to comply with post term covenants relating to the use of franchisor's trade secrets and know-how may even be unenforceable.[13]

V. TAXATION LEGISLATION

Government imposition of taxes is a universal phenomenon, but the mechanics and scope of national, state or provincial taxation legislation varies significantly. In the franchise context, before embarking on any venture, care must be taken to determine what are the local sales, property, income and withholding taxes applicable in a given jurisdiction.

Insofar as international taxation is concerned, frequently the taxation consequences can fluctuate depending on how the franchise arrangement is structured and the existence of treaties between the countries involved. These matters are more fully discussed in Chapter XIV.

VI. CORPORATE LAW AS WELL AS LAW RELATING TO THE ESTABLISHMENT OF JOINT VENTURES

Another consideration related to the structure of the franchise arrangement is compliance with local corporate laws including laws relating to the establishment of branch offices and the entering into of joint venture arrangements. With the conversion of the economies of many of the countries in eastern and central Europe to "market economies" the world has witnessed a proliferation of legislation relating specifically to the establishment of joint ventures by foreign nationals. Like other types of legislation, corporate laws vary from country to country. Before commencing business in a particular jurisdiction, care must be taken to observe the formalities associated with the respective corporate laws. This issue becomes particularly relevant in countries with laws restricting ownership of shares in incorporated companies by foreign nationals.

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[13] See section entitled "Restrictive Covenants and Ownership of Know-How Following Expiration of the Term of the Agreement" which appears in Chapter VIII.

Corporate laws may also include provisions requiring registration of foreign companies and the amount of capital that may be invested. Other corporate laws may provide that a majority of directors must be nationals of the country in which the corporate entity has been incorporated. Moreover, it would be prudent for the franchisor to familiarize himself with the duties and responsibilities of directors and shareholders in the foreign country.

VII. EXCHANGE CONTROLS AND LIMITATIONS ON ROYALTIES

As a general rule, the amount of royalties remitted by a franchisee is not subject to specific limitations in developed countries. In under-developed countries, however, central financial authorities such as central banks or foreign exchange regulators, will often regulate both the amount of royalties which may be paid pursuant to a contract as well as the flow of funds into and out of the country.

In the event that there exists limitations on the rate of royalties in a country, it does not matters that a franchise agreement was negotiated in good faith and at arm's length. Any contract exacting fees in excess of the rate permitted may be subject to government review and an order for reduced royalties.[14]

VIII. CONTRACT LAW

It is clear that many countries have enacted legislation which impacts on the theory of freedom of contract, even by parties dealing in good faith and at arm's length who wish to enter into a contractual arrangement. This trend is particularly prevalent in under-developed countries and especially insofar as they relate to foreign investments in those countries and the payment of royalties for the use of trade marks and know-how. Many countries have enacted laws which regulate on a broad basis all contracts between local entities and foreign enterprises. Moreover, in other countries, certain distributor or agency laws exist which specifically regulate relations with distributorships and/or representatives or agents. These laws could in certain instances limit the ability of the franchisor in such contractual areas as dispute settlement, choice of law and jurisdiction, damage or sanction clauses, foreign exchange provisions, contract language, and other similar formalities and matters.

IX. IMPORT/EXPORT CONTROLS

Most countries have a host of laws regulating both the quality and quantity of what may enter and leave its boundaries. These laws may take the form of tariffs and duties, import quotas, import licensing requirements, extraordinary import licensing restrictions, and other similar limitations that could affect the ability of a franchisee to produce and market a particular product or service.

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[14] These matters are dealt with more fully in the section entitled: "Existence of Specific Laws in a Foreign Country" in Chapter IV.

In addition to the foregoing, the establishment of standards for certain products that are being imported into the foreign country can similarly impact on the franchisee's ability to acquire such products in the foreign country.

X. LABOUR LAWS

Many countries have laws applicable to employers that govern aspects of the employment relationship, including those that establish minimum wages, maximum hours of employment, and compensation or reinstatement for unjust dismissal. Moreover, there may also exist a wide range of add-on costs to the employer that vary according to the degree of social security available. In addition, there may exist other laws which specifically affect the employment of foreigners.

XI. INVESTMENT LAWS

In certain countries the franchisor may be prohibited or restricted from owning shares in the company established in the foreign country. In addition, other laws may require the franchisor to obtain special registration or approval for operating within the foreign country.

XII. PACKAGING AND LABELLING LAWS

Most countries have legislation specifically requiring packaged products to comply with standard sizes as well as with labelling requirements including the language that must appear on individual labels. In addition, products which are imported may be required to disclose certain information relating to the nature and quality of the product, the name of the manufacturer and importer as well as the country of origin.

XIII. FOOD AND DRUG LAWS

Many countries have enacted legislation which impact on the sale of food and drugs, including cosmetics. The contents, labelling and advertising of such product will be affected by such legislation. Moreover, in many cases, such products must be approved by a regulatory authority prior to their being offered for sale in a particular country.

XIV. IMMIGRATION LAWS

The existence of laws restricting the presence of foreign representatives of a franchisor can, of course, negatively impact on the establishment of the franchise system in a foreign country. Most foreign personnel who are engaged in business activities may be subject to these requirements and may require special tax clearance procedures, restrictions on the period during which the foreign representative may stay in the foreign country and other such limitations. All of these matters can affect the ability of the franchisor to train the franchisee in the foreign country, the supervision of the franchise system by the franchisor and other similar matters requiring the use of foreign personnel.

CONCLUSION

The foregoing is only intended to briefly mention some of the laws which may impact on the establishment and development of a franchise system in a particular country. What is abundantly clear is that the franchisor must familiarize himself with all such legislation prior to entering into a franchise agreement. This is especially true where the franchisor intends to franchise directly into the foreign country as opposed to entering into a master franchise or joint venture arrangement. Moreover, the existence of certain laws will impact on his choice of the method or the commercial vehicle to be used by the franchisor in exporting his franchise system to a particular foreign country.

Part of a chapter contained in a book entitled "International Franchising" authored by A.S. Konigsberg to be published by Transnational Juris Publications, Inc.

V. FACTORS TO CONSIDER IN DETERMINING THE MOST APPROPRIATE COMMERCIAL VEHICLE OR METHOD FOR USE IN INTERNATIONAL FRANCHISING

Before proceeding to an analysis of the three commercial vehicles or methods, it is prudent to examine some of the factors, legal or otherwise, which should be taken into account by a franchisor before he chooses the most appropriate vehicle for his particular circumstances and needs.

Generally, where the foreign country and the franchisor's country are geographically near, and where the language, culture and customs of the two countries are similar, as is the case between Canada and the United States, all three vehicles or methods are available to the franchisor. Conversely, the greater the distance and/or differences in language, culture and customs, the realistic alternatives available to a franchisor are more limited. In addition, where the franchisor has readily available and experienced management personnel and/or sufficiently available financial resources, the greater are the number of alternatives available to him.

Moreover, the franchisor who has readily available financial and human resources would generally choose one of the direct methods of franchising into a foreign country, as opposed to master franchising or even a joint venture, since he will stand to derive a greater economic benefit from direct franchising. This should be obvious since in direct franchising, although his expenses will be greater, he will realize the full benefit of all fees payable by franchisees, and will not have to share them with a sub-franchisor or a joint venture partner.

The following are some of the more important factors that a franchisor should take into account prior to making his decision as to ~~which of~~ the foregoing commercial vehicles bests suits his needs with regard to a particular country.

(1) Availability of human resources: - The franchisor must honestly assess the availability and quality of management personnel who would be charged with establishing the franchise system in the foreign country. Certainly, direct franchising should not be considered as an alternative unless the franchisor has available management personnel of sufficient quality and quantity as to permit several of them to be assigned to the foreign country for significant periods of time. Moreover, the franchisor who wishes to directly franchise must be prepared to hire foreign personnel who are familiar with the laws, customs, habits, tastes, business culture and commercial practices of the foreign country. In addition, it would not be prudent for such franchisor to rely solely on newly hired foreign personnel, given their lack of knowledge and intimacy with the nature of the franchisor's business, the franchise concept and system in general and with the franchisor's corporate culture. Thus, it would be advisable for the franchisor who does not have the availability of manage-

ment personnel to consider master franchising or a joint venture arrangement.[15]

(2) Financial resources available to the franchisor: - It has been frequently mentioned that the experience of most franchisors who have tried to establish their franchise business in a foreign country is that it often turns out to be significantly more costly than previously envisaged.[16] Coupled with this is the length of time it takes to identify a suitable party in the foreign country who will act as a manager, developer, sub-franchisor or joint venture partner, as well as the time it takes to successfully negotiate an international franchise agreement. In both cases, it will take considerably longer time than it takes to find the appropriate person and to negotiate a similar agreement in the franchisor's country. All of this adds to the costs.

Moreover, the pay back period, that is, the time it takes the franchisor to realize a profit from his international franchise operations within a foreign country, would appear to be considerably longer than that involved in

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15. Walker, supra, Chapter II, note 1, concluded on page 23, that the necessity of the franchisor having the appropriate present and future levels of resources, including both financial and managerial resources, was "underscored by the survey finding that the commitment to international expansion of sufficient managerial resources from headquarters is one of the more significant prerequisites for success".

16. See Walker, ibid., p.23.

domestic franchising.[17] The tendency on the part of franchisors to under-estimate the costs combined with the lengthy time factors involved will usually wear a franchisor's patience thin, resulting in ever increasing pressures to cut costs.

Finally, the franchisor should be aware that in financing his international expansion he may be using up financial resources that might be better used in supporting or expanding his domestic operations.

Thus, franchisors with limited financial resources available to export their franchise systems should avoid direct franchising and rely on master franchising or even a joint venture arrangement.

(3) Physical distance between the franchisor's country and the foreign country: - The question of physical distance between the franchisor's country and the foreign country must be considered as a critical factor. As was previously pointed out, all of the alternatives would generally be available to a U.S. franchisor wishing to export his franchise system into Canada, insofar as franchise outlets situated in Canada would ordinarily be at no greater distance to any particular point in the United States than

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[17] Zeidman, *supra*, note 10, on page 37 of his paper concluded that:

> Patience seems to be the primary requirement for doing business successfully in foreign markets. Several companies, for instance, have discussed the number of years before international units began to show a profit, with eight to ten mentioned frequently.

would franchise outlets in the United States. Conversely, the greater the distance, the fewer the alternatives available to a franchisor. Walker confirmed this factor in his report when he found that, "The country or area chosen as the site of the first unit franchise outside the U.S. represents a critical decision for a franchisor. The level of success of this unit and the degree of difficulty connected with operating in this area probably have a major effect not only on whether further international expansion occurs but also where it occurs." Furthermore, the survey found that over eighty percent of responding U.S. franchisors had unit franchises in Canada. The next country most attractive for U.S. franchisors was the United Kingdom, with thirty percent having franchise outlets in that country.[18]

(4) Availability and quality of communications system: - The availability of a proper telephone, telex or facsimile system between the different countries may not necessarily be a determining factor, but it is nevertheless something that should be considered. In addition, the ability to travel easily and quickly from one country to another is a factor that must also be taken into account.

(5) Training of franchisees: - If the franchise system is a complicated one requiring extensive training of franchisees, it will necessarily impact on the options available to the franchisor as it may require the establishment of a training facility in the foreign country. The resulting costs and difficulty of staffing such a facility may become an influential factor to be considered by the fran-

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[18] Walker, supra, Chapter II, note 1, p.6.

chisor. Thus, should the franchisor conclude that whether due to costs, distance or other factors, he could not properly establish a training facility in the foreign country, it would be advisable for him to opt for master franchising or even a joint venture arrangement as opposed to direct franchising.

(6) Differences between the franchisor's country and the foreign country: - The problem of differences in language, culture, ethics, tastes, habits, customs and attitudes will also play an important role in the choice of alternatives available to the franchisor.[19] These differences are all critical factors, each of which must be taken into account. For example, different languages should not only be treated as a nuisance factor but should also be considered from the point of view that it will prolong and render more difficult the negotiating of agreements, thereby increasing the likelihood of misunderstandings between the parties. It will equally impact on the quality of the franchisor/franchisee continuing relationship and greatly increase costs since agreements as well as manuals, advertising and promotional materials will have to be translated. Finally, the training of franchisees will be rendered more difficult. Moreover, something which must be taken into account by the franchisor is that differences in cultures, tastes, habits, etc.

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[19] Zeidman, supra, note 10, in discussing the problems associated with international franchising on p. 73 of his paper concluded that:

> The prospects for franchising in Japan, or elsewhere, lie in understanding the market. And understanding the market requires understanding the society. Virtually every facet of the character of the people, the society and the economy has implications for franchising.

may well require that changes be made to the franchise system. Where these differences are not significant, all alternatives are generally available to the franchisor. Where these differences become important, the franchisor may want to rely on a joint venture partner or a sub-franchisor under a master franchise relationship who is familiar with the language, culture, ethics, etc. of the foreign country to establish his franchise system rather than undertake the responsibility himself.

(7) Differences in legal systems, laws and commercial practices: - Experience has indicated that significant differences in the legal systems, laws and commercial practices between the franchisor's country and the foreign country have proved an intimidating experience to franchisors. Generally speaking, where both countries have similar legal systems, laws and practices, all of the alternatives discussed above would be available to a franchisor.

It is possible, however, that this issue may not be as important for U.S. franchisors as it is for franchisors of other countries. The United States is clearly the country which has the most comprehensive legislation dealing with franchising, and accordingly the existence of differences may not prove to be as intimidating a factor for U.S. franchisors.

It should be noted that even for a Canadian franchisor who wishes to franchise in the United States where in many cases the legal systems and commercial practices are largely similar, the experience can nevertheless be unnerving. The prospect of the Canadian franchisor himself seeking compliance with franchise registration requirements or the prospect of the Canadian franchisor facing the legal problems occasioned by U.S. anti-trust legislation and, in particular, those problems caused by what are perceived as incredibly high quantum of damages awarded by U.S. courts in anti-trust or other lawsuits affecting franchising, may lead Canadian franchisors to avoid direct franchising and to concentrate on master franchising. Conversely, for a U.S. franchisor wishing to export his franchise into Canada, the relative absence of legislation relating to franchising,[20] the comparable lack of cases relating to anti-competition matters, the relative absence of litigation involving franchising and the comparatively modest quantum of damages awarded by Canadian courts, makes Canada an easy country into which a U.S. franchisor may export his franchise system.[21]

(8) Existence of specific laws in a foreign country: - The existence of certain laws in the foreign country will have a direct influence on the franchisor. For example, the effect of certain laws may make it impossible to set up a

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[20] It should be noted that the Province of Alberta is the only province in Canada that has enacted legislation specifically relating to franchising.

[21] Walker, supra, Chapter II, note 1, in his Study concluded on pages 17 and 18 that "of responding U.S. franchisors, more than 57% of those who had international operations, initiated their international expansion in Canada while more than 65% of responding franchisors with international units, indicated that Canada would be their first choice." Walker further concluded that "Canada's proximity and similarity to the U.S., including for the most part a common language, makes this country an attractive area in which to commence international expansion".

branch office or subsidiary in the foreign country so that the only available alternative to a franchisor is to engage in a joint venture or to enter into a master franchise arrangement with a national of the foreign country.[22] However, even the entering into of a master franchise agreement may not be feasible in certain countries.[23]

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[22] A good example of a country where it is difficult, if not impossible, to establish a branch office or a wholly-owned subsidiary, is Mexico. In the chapter on Mexico appearing in the Survey of Foreign Laws and Regulations Affecting International Franchising, supra, Chapter I, note 3, it was pointed out at pages 20 and 21 thereof that:

> although Mexican law and theory contemplate the establishment of a branch, in practice the necessary permit is almost never granted. .... Mexican law generally prohibits foreigners from owning more than 49% of a new Mexican company. .... As mentioned, Mexican law prohibits foreigners from participating in the management of a company which is disproportionately greater than its participation in the equity of the company, and even insertion of 'negative controls' in the charter and by-laws may not be valid, although it is commonplace.

However, the Editor's Note appearing in the introduction to the chapter on Mexico pointed out that:

> ... in May 1989 the Mexican Government radically liberalized restrictions on investment in its economy by foreigners and undertook to reduce the discretion and delays of the bureaucracy applying the restrictions. ... The final effect and scope of these complex provisions is unknown, although they and their administrators clearly proclaim a new departure.

As was discussed in great detail in Chapter III, laws relating to intellectual property rights, equity investment, fiscal and currency matters, exchange controls or other restrictions on the repatriation of franchise fees or dividends, and delays in obtaining necessary governmental or central bank consents are all important factors to be considered. Again, the existence of specific laws, for example, those which impact on the transfer of know-how, may inhibit the normal negotiating process between parties who should ordinarily be dealing with franchisees at arm's length and as equals.[24] They may also affect the abi-

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[23] In the Republic of China (Taiwan) for example, it would appear that entering into a master franchise arrangement would not be permitted by the regulatory authorities. The chapter on the Republic of China contained in the Survey of Foreign Laws and Regulations Affecting International Franchising, supra, Chapter I, note 3, indicated at page 13 that:

> Sub-franchising is not feasible in Taiwan. For example, the licensing of trademarks in Taiwan is subject to prior approval by the NBS. According to the ROC trademark law, the NBS must ensure that the licensor of a trademark will exercise control over the use of the trademark by the licensee and that the quality of goods under the trademark complies with the licensor's standards. There can be no assurance that sub-licensees will meet such control and quality requirements. Thus, the NBS is not likely to approve the sub-licensing of trademarks.

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[24] Examples of countries which have enacted legislation which places severe limitations on the ability of a franchisor to negotiate at arm's length with his franchisees, the amount of royalty and other payments due to the franchisor are Brazil, Korea and Taiwan. As a result of such legislation, the franchisor is required, for all intents and purposes, to negotiate the amount of royalties and other payments directly with governmental agencies as opposed to dealing directly with his franchisees.

In Brazil, payments of royalties and other fees for technical assistance are subject to limitations established by the Ministry of Finance by Regulation no. 436 on December 30th, 1958. As a result, a franchise agreement which requires the payment by a franchisee in Brazil of royalties and other technical assistance fees in foreign currency must be approved by the National Institute of Industrial Property ("INPI") and the Central Bank of Brazil prior to the agreement being approved for registration. Typically, these institutions have limited the rate of royalty payable for the use of patents and the fees for the transfer of technical assistance to certain percentages which vary, depending on such circumstance as how essential the products involved are to the Brazilian economy, from one to five percent. With regard to royalties payable for the use of trade marks, the limit appears to be set at one percent irrespective of the product used or service offered in connection with the trade marks. For a further elaboration of these matters, see page 23 of the chapter on Brazil which appears in the Survey of Foreign Laws and Regulations Affecting International Franchising, supra, Chapter I, note 3.

Similarly, in the Republic of Korea, where a royalty is the only payment to be made for the grant of a license, the maximum rate of royalty that will be permitted is ten percent. However, it would appear that this percentage is subject to negotiation depending on what the Government perceives to be the value of the technology and know-how that is being licensed. As was pointed out at page 8 in the chapter on Korea which appears in the Survey of Foreign Laws and Regulations Affecting International Franchising, supra, Chapter I, note 3, "In the case of technology for low priority industries, including fast food restaurants, the permissible maximum lity of the franchisor to preserve the integrity of the franchise system in the foreign country or the manner in which his trade marks are being used.

(9) *Political systems and stability factors*: - The political system of the foreign country and the historical stability of its governments must, of course, be taken into account. Where a particular franchise is, by its nature, highly visible, a franchisor may not want to put at risk his own capital. Similarly, where a particular country is perceived as being relatively unstable, master franchising may be the only viable alternative.

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royalty rate appears to be in the range of one to three percent (1-3%)".

In Taiwan, the Investment Commission has been granted discretion in determining what royalty rates and other fees are acceptable to the Government. In the Chapter on Taiwan appearing in the *Survey of Foreign Laws and Regulations Affecting International Franchising*, *supra*, Chapter I, note 3, it was pointed out on page 6 that:

> In general, royalty rates which have recently been approved by the Investment Commission have ranged from two percent (2%) to four percent (4%) of net sales, computed with reference to a 'net sales' formula devised by the Investment Commission. As with all aspects of franchising arrangements, limitations placed on royalty rates are generally determined according to the Commission's perception of the technological benefit to be gained from the particular type of operation. Thus, fast-food franchises have rarely been granted rates higher than four percent (4%) of net sales, while some pharmaceutical distribution agreements have been accorded royalty rates as high as fifteen percent (15%). Franchisors are likely to continue testing the larger trend towards investment liberalization by seeking higher royalty rates.

(10) Level of economic activity: - The foreign country's general level of economic development and growth as well as the size of its middle class and the general level of disposable income within the country are all factors to be taken into account.[25] In addition, the attitudes adopted by foreign governments to international trade, foreign investment and more particularly, its level of importation of specific goods and services which are important to the franchise system, should be taken into by the franchisor. Moreover, the availability of desirable methods of barter and counter-trade between certain countries involved may also be an interesting factor to consider.

(11) Nature of the products and services: - Certain products and services which are being distributed through the franchise system may better lend themselves to being franchised through one commercial vehicle as opposed to another. For example, the establishment of a real estate franchise system in a foreign country has traditionally been carried on through the grant of a master franchise as opposed to direct franchising.

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[25] Kauffman and Leibenstein, supra, note 12, concluded that:

> In addition to differences in taste, differences in the economic environment may radically alter the way a franchise system functions in a foreign market. Franchising typically focuses on serving the needs of a particular market segment. If a franchise concept is introduced into a foreign market, it might attract an entirely different consumer segment. For example, a concept that relies on relatively high levels of disposable income might attract middle-class consumers in an industrialized nation, but attract upper-class consumers in a developing economy.

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STATEMENT OF DEBRA BOLLINGER

DIRECTOR, SOUTH DAKOTA DIVISION OF SECURITIES

on behalf of the
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

before the

COMMITTEE ON SMALL BUSINESS
U.S. House of Representatives

FRANCHISING IN THE U.S. ECONOMY

September 27, 1990

President: M. Douglas Mays (Kansas) • **President-Elect:** John R. Perkins (Missouri) • **Secretary:** John B. Hiatt (New Mexico)
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Richard D. Latham (Texas) and Wade Nesmith (British Columbia) • **Executive Director:** Lee Polson

Mr. Chairman and Members of the Committee:

My name is Debra M. Bollinger. I am Director of the Securities Division of the South Dakota Department of Commerce and Regulation. I also chair the Franchise and Business Opportunities Committee of the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 state agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level. On behalf of NASAA, I appreciate the opportunity to appear before you today.

Mr. Chairman and Members of the Committee, you are to be commended for conducting an examination of franchise-related issues. Oversight of franchise offerings is an important consumer protection for the hundreds of thousands of existing and potential franchisees and requires the close attention of both the federal and state governments. We welcome your interest in studying the adequacy of state and federal franchisee safeguards and look forward to working with you and your staffs on this very important consumer protection issue.

The August 1990 staff report of this Committee, Franchising in the U.S. Economy: Prospects and Problems,[1] makes many valuable contributions to this debate. The report presents a comprehensive overview of the franchise industry, its role in the economy and the current regulatory system. In addition, it provides a conceptual framework for a discussion of the public policy questions that have emerged as franchising occupies an increasing prominence in our economy and affects the financial well-being of more and more individuals. Finally, the staff report serves as a compelling reminder that we must continually evaluate, update and modernize our regulatory programs to keep pace with developments in the franchise marketplace.

You have set out a detailed list of questions to be covered in this hearing. The comments of NASAA will focus on those issues which address whether federal and state franchise regulatory programs adequately protect the interests of franchisees, franchisors and consumers. Questions concerning the effectiveness of franchising as a method of business operation and the role of franchising in the U.S. economy are best left to those witnesses directly involved in franchising, either as representatives of franchisors or franchisees.

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[1] Committee on Small Business, House of Representatives, Franchising In the U.S. Economy: Prospects and Problems, August 1990, Committee Print 101-4.

THE RISE OF FRANCHISING

Many will remember the decade of the 1980s for its focus on big business: Headlines championed Wall Street dealmakers who forged multi-billion dollar takeovers and leveraged buyouts; we closely followed the ups and downs in the finances of high-flying speculators, including Donald Trump, Michael Milken and Ivan Boesky; and we learned in great detail about the sophisticated trading techniques of institutional investors who moved hundreds of millions of dollars at the push of a computer button. What many may have missed, however, was an equally dramatic -- though much less celebrated -- transformation in the way business on Main Street is conducted. In fact, it was during the last decade that franchising emerged as one of the most significant forces in the nation's economy.

According to the International Franchise Association (IFA), there are now more than 500,000 franchise outlets employing 7.7 million workers nationwide. Numbers from the United States Department of Commerce[2] chart the phenomenal growth in the franchising industry. Department reports show that sales by business format franchisors have been growing by approximately 10 percent per year -- nearly five times faster than the gross national product. In 1975, franchisees rang up gross receipts estimated at $186 billion. A decade later, that figure had ballooned to $529 billion. And, it is expected that the sale of goods and services this year by franchisees will exceed $716 billion, accounting for more than one-third of all retail sales in the nation.

The explosion in franchising is expected to continue unabated into the next century. Earlier this year, a franchising consulting firm,[3] predicted that the number of franchise parent companies will triple in the 1990s, from 3,000 to 9,000. By the year 2000, franchising is expected to account for fully half of all retail sales and, observes Time magazine, "will be the primary method of doing business in America."[4] According to a survey of 229 large and small franchise companies, the growth in franchising will be fueled in part by a larger pool of prospective buyers as more baby boomers come into their "franchise buying years."

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[2] U.S. Department of Commerce, Franchising in the Economy 1986-1988 and Franchising in the Economy 1982-1984.

[3] Mark Robichaux, "Franchise Firms Get Good News on the '90s," Wall Street Journal, February 23, 1990.

The Committee's staff report attributes the increase in franchising activity to "a rising sense of entreprenuerism among key groups within the population, together with increasing limits on the ability of companies to expand by more traditional means ..."[5] Fewer opportunities for advancement in the corporate world also has prompted growing numbers of women, minorities, early retirees and immigrants to seek franchise and other business opportunities. As the economy undergoes even further constriction, experts predict that thousands of former mid-level executives will look to franchising arrangements as a way to get into business for themselves. While most franchises are legitimate investment opportunities, fraud has been a substantial problem.

THE "DARK SIDE" OF FRANCHISING

The broad state regulatory experience generally warns that fraud and abuse usually follows closely on the heels of an industry that is undergoing explosive growth and enjoying substantial public interest. The franchising industry has proven to be no exception. It has been observed that, for every headline grabbing story about someone made a millionaire by McDonald's, Wendy's, or some other franchisor, there are quieter stories about unknown people who have been made poor by unknown -- and often nonexistent -- franchise businesses.

The business of franchising is surrounded by a grand myth, a myth given life by the success stories of franchising. Buy a franchise -- buy someone else's idea, or expertise and support -- and you buy success, or so the myth goes. But the reality can be much starker, particularly for those who buy a new franchise. In fact, it was the many and serious problems that arose in connection with the offer and sale of franchises during the 1960s and 1970s that spurred first the states and later the federal government to move in to protect consumers from promoters of fraudulent or abusive schemes. Case after case has demonstrated that franchise fraud leaves in its wake failed dreams of financial independence and the loss of homes and the hard-earned life savings of unwary investors.

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[4] ____, "We Do it All For You," Time, July 16, 1990, pp. 42-44.

[5] Franchising In The U.S. Economy, pp. 12-13.

This hearing is particularly timely given the warning issued just last week in the Wall Street Journal that "fraud in franchising and the sale of business opportunities is on the rise, fueled in part by a faltering economy."[6] R. Norman Cramer of the Federal Trade Commission's (FTC) Denver Office explained why the number of potential victims of such scams tends to rise as the economy sours: "That's because people who have been laid off or pushed into early retirement often dream of owning their business -- and have big severance or benefit checks to invest."[7]

If reports that home-based franchises are growing in popularity are, in fact, borne out, we may now see a new wave of fraudulent deals peddled to even less sophisticated consumers. The economy's strong service sector is said to be spinning off many low-budget franchises that can be run from home. The rising number of people working at home, at least part-time, supplies a growing, and largely untapped, market for franchisors. "There are lots more people who have $12,000 to invest than $200,000," notes Robert Kushall, a Glen Cove, New York franchising consultant.[8] As franchisors reach down into the ranks of less and less financially-sophisticated consumers, we are deeply concerned that those least able to afford to it now will be the targets of unscrupulous operators promoting so-called "low budget" franchises.

A 1970 study of the operations of franchise promoters conducted by the staff of New York Attorney General[9] concluded that, "[i]n almost 100 percent of the [500] cases where the Attorney General obtained the literature used to promote sales, the offering literature was either misleading or failed to state all the material facts." The report said that, in many instances, the franchise companies were fly-by-night operations, whose first and last bestowals upon "their franchisees" were elaborate brochures setting forth blatantly false promises of prospective franchisee income and franchisor performance. The report further noted that companies often were created solely to profit from the sale of franchises and not from their underlying retail business operation, if any even existed. Other conclusions of the 1970 report:

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[6] John R. Wilke, "Fraudulent Franchisers Are Growing," Wall Street Journal, September 21, 1990.

[7] Ibid.

[8] Barbara Marsh, "Franchisees See Home as Place to Set Up Shop," Wall Street Journal, February 12, 1990.

[9] New York Department of Law, A Report to the Attorney General, 1970.

- Knowledge and background necessary to set up a successful operation often was lacking;
- In many cases, the promise of support from the franchisor either was not forthcoming or was worthless;
- Criminal elements and unscrupulous high-pressure salesmen had infiltrated operations of the franchise business; and
- Misrepresentation and fraud in the offer and sale of franchises was rampant.

In urging passage of the Franchise Sales Act, the New York Attorney General testified in 1980 before the state's Senate Consumer Protection Committee that, in the preceding eight year period, 14,000 New Yorkers lost $40 million to franchise frauds. The Legislature concluded that the substantial losses suffered by New Yorkers were due to the failure of franchisors to provide:

> "... full and complete information regarding the franchisor-franchisee relationship, the details of the contract between the franchisor and franchisee, the prior business experience of the franchisor, and other factors relevant to the franchise offered for sale."[10]

As the report of the New York Attorney General's Office pointed out, the most serious and widespread abuses in franchising during the late 1960s and early 1970s were found to involve actions or misrepresentations occurring prior to the initiation of franchise agreements. In numerous proceedings and investigations during the 1970s, the Federal Trade Commission (FTC) documented complaints of fraud or misrepresentation against more than 170 franchisors filling some 5,700 pages in ten volumes of public records. Based on this data, the Commission concluded that there had been "widespread evidence of deceptive and unfair practices" in franchise solicitation and sales. The most common abuses were found to involve misrepresentation or failure to disclosure material facts relevant to the true nature or value of a franchise, and the use of unsubstantiated earnings claims or deceptive earnings representations. Such abuses had occurred, the FTC concluded, due to the "informational imbalance" that existed between franchisors and potential franchisees.[11]

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[10] See, Letter of Alice McInerney, Assistant Attorney General in Charge, Investor Protection and Securities Bureau, New York Department of Law, to Donald Clark, Secretary, Federal Trade Commission, Re: Comment on Advance Notice of Proposed Rulemaking - Franchise Rule, FTC File No. R511003, June 16, 1989.

FRANCHISE REGULATION: AN OVERVIEW

To the extent that fraud and abuse in the franchise arena has diminished over the last several years, such improvement largely is attributable to the combined efforts of state and federal authorities. Regulation of franchising activity developed in response to the widespread concern about shady franchising schemes that flourished in the 1960s and early 1970s. The August 1990 staff report of the Small Business Committee identified two major consumer protection concerns in the franchise arena:[12]

- Problems which arise prior to entering into a franchise relationship, particularly deception or impropriety in the presentation, solicitation or sale of a franchise opportunity; and
- Problems arising within ongoing franchising relationships, generally involving contract performance, termination or renewal of franchise agreements.

The state-federal regulatory scheme now in place is aimed primarily at ensuring that prospective franchisees are provided with adequate and meaningful information with which to make their investment decisions and, in some instances, to ensure the financial viability of the franchisors.

State Regulation

Oversight of franchising at the state level is based on a recognition that a regulatory program is most effective when it includes three key elements: prevention, detection and prosecution. If one or more of these main elements is not fully incorporated, the regulatory system is incomplete and may be ineffective. The state franchise regulation system is rooted in the traditional commitment of grassroots officials to protect consumers whenever possible before they part with their money; and in those cases where money is lost in a fraudulent deal, to marshal the enforcement resources in an aggressive campaign to shut down the violator and seek restitution if possible.

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[11] 43 FED. Reg. 59627, 1978.

[12] Franchising In The U.S. Economy, p. 21.

California adopted the first state franchise statute in 1971. Today, 15 states[13] have statutes which regulate the offering of franchises for sale. Thirteen of these states[14] operate under similar or uniform statutes which require registration with a state agency and delivery of disclosure documents to prospective franchisees prior to an offer and sale of a franchise. Registration laws are designed to prevent fraud in the sale of the franchise and disclosure laws are intended to provide each prospective franchisee with the information necessary to make an intelligent decision regarding the franchise being offered. Further, state laws bar the sale of franchises where such sales would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled. Although all states do not require registration of franchise offerings, few franchisors sell in non-registration states only. Thus, reviews conducted by registration states have raised the standard of disclosure generally in the franchise market.

Key elements of state franchise law include:

- Comprehensive disclosure to franchisees, ranging from the business and litigation history of the company and its officers to updated corporate financial figures;
- Civil and criminal sanctions for noncompliance. These sanctions apply not only to failure to register or disclose completely and accurately but also to certain prohibited acts such as fraud and misrepresentation; and
- Remedial rights to injured franchisees.

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[13] California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

[14] California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. In addition, Oregon requires disclosure prior to the sale of franchises, but does not have a registration or filing process. Michigan requires disclosure and the filing of a "notice of franchise offering."

Compliance with state regulatory requirements generally is satisfied by filing the Uniform Franchise Offering Circular (UFOC) and other relevant documents with the appropriate state agency. The UFOC, a disclosure document adopted by the states in 1975 in a move toward greater uniformity, is accepted in all the states which require the registration of franchises. While there may be minor differences in individual state requirements, franchisors can handle these variances simply and easily by use of a state specific addendum page.

The UFOC requires franchisors to provide certain information to prospective franchisees, including:

- Details on the franchisor's business and the people running the company, including a history of criminal and civil litigation and bankruptcy;
- Fees that will be charged, including one-time and recurring charges;
- Purchasing and leasing obligations;
- A description of the role the franchisor will play in the start-up and operation of the franchise and obligations of the franchisee to participate in the operations;
- Description of any exclusive area or territory granted under the franchise agreement;
- Conditions imposed which may restrict what the franchisee may sell or to whom the franchisee may sell;
- Details concerning the renewal, termination, repurchase, modification and assignment of the franchise agreement; and
- Financial statements and contracts.

State franchise laws satisfy the first component of an effective regulatory program -- prevention -- through the requirement that the disclosure documents, such as the UFOC, be filed and reviewed by trained state personnel. Through their efforts, state examiners ferret out those proposals that are fraudulent or abusive, and thereby protect state consumers before they have parted with their money.

An example from South Dakota illustrates how the state registration and review process weeds out blatantly fraudulent or abusive franchise offerings. **Invest America Inc**. wanted to market franchises for the operation of financial planning businesses. The company president had previously been convicted of federal securities fraud and had been the subject of an action by the FTC which resulted in injunctions enjoining him from a variety of fraudulent, unfair and deceptive practices. A member of the company's board of directors was the defendant in a civil action for fraud and misrepresentation. None of this information was disclosed in the franchise offering circular. Further, the company's financial statements revealed an inability of the company to fulfill its obligations to franchisees. South Dakota and other states denied the franchise registration to Invest America Inc. and saved untold numbers of potential franchisees their hard-earned money.

Thus, the main benefit of registration with a state agency, as opposed to simply requiring disclosure to prospective franchisees, is that it also serves as an enforcement tool -- it is a mechanism for screening out fraudulent or abusive offerings before they reach the public. Because offering documents must be filed with the state agency, states also serve as an important repository of information for prospective franchisees to compare documents from various franchisors. In many instances, this information is crucial to the process undertaken by investors to evaluate franchise deals. Finally, an additional important benefit of registration laws is the authority granted to securities administrators in these states to require that franchise fees and other funds paid by the franchisee be held in escrow until the franchisor's obligations to the franchisee have been satisfied.

The "detection" and "prosecution" components of the state franchise regulatory system form the basis of enforcement programs. State officials are not satisfied with simply policing those franchisors who file for registration. Rather, state registration and enforcement staff are uniquely positioned at the grass-roots level to spot and move against fly-by-night franchisors attempting to skirt the laws and rules governing the offer and sale of franchises. State officials scrutinize the classified advertisements in national and local newspapers for evidence of unregistered franchisors soliciting their state residents. Most state officials similarly frown upon unregistered franchisors participating in trade shows and prevent them from offering franchises to state residents until they have satisfied the relevant requirements.

The states have a broad assortment of enforcement tools available under the franchise laws which allow them to move swiftly and decisively against violators. States may issue orders prohibiting violations of the law, as well as orders denying, suspending and revoking registration and exemption of franchises. In addition, states have injunctive and criminal referral authority.

The State of Wisconsin[15], for example, over a five year period (1983-1988) took enforcement actions in 26 franchise cases. The actions included four criminal referrals, two injunctions, 14 orders of prohibition, five warning letters and one assurance of discontinuance. In two separate actions, the Office of the Commissioner of Securities recovered more than $27,000 in lost franchisee dollars. A review of the 1986-1987 enforcement program of the California Department of Corporations[16] reveals that its Division of Enforcement handled 147 franchise cases, 61 of which had resulted in action at the time of the report (66 cases were still open or under investigation). The results of the enforcement program included five criminal actions, 42 desist and refrain orders, 12 registration denials, revocations or suspensions, and two injunctions.

Franchisees in registration states benefit tremendously from the private right of action granted under state law. A private right of action allows consumers to sue for damages when they sustain losses due to franchise law violations. The experience of state regulators is that private remedies serve as a necessary supplement to governmental regulation and enforcement efforts in providing a deterrence to abuse. Without private remedies, injured franchisees only can be protected through governmental action. This in turn places a greater premium and demand on the already strained resources of the regulatory agencies and frequently means that fewer injured franchisees can be "made whole" than would be the case if a private right of action was explicitly authorized in the law.

The Role of NASAA

An important goal of the North American Securities Administrators Association (NASAA) is the promotion of efficient and uniform state laws. In the franchise regulation area, it is NASAA's intention to move forward and continue the serious efforts we have undertaken to promote uniformity of state law, provide enhanced training and educational opportunities for state franchise personnel, seek ever more cooperative relationships with the Federal Trade Commission, and solicit the advice and input of franchisors and franchisees.

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[15] See, Letter from Walter White, Wisconsin Commissioner of Securities, to Donald Clark, Secretary, Federal Trade Commission, Re: Franchise Rule, FTC File No. R511003, June 14, 1989.

[16] Judy Hartley, "Overview of the Department of Corporations Enforcement Program: Franchise Investment Law," Franchising 1988: Business Strategies and Legal Compliance, p. 396.

Three years ago, NASAA sponsored its first ever franchising training and education seminar for state personnel. This successful program provided an opportunity for franchise regulators across the country to gather together to discuss common problems and solutions. We have continued the training and education program and expect that it will remain a staple in our efforts to promote uniformity among the several states.

Through the ongoing efforts of NASAA and its Franchise and Business Opportunities Committee, there has been a steady review of the substance of state franchise disclosure regulations to improve their utility, enhance uniformity, encourage new industry entrants and simplify the legal requirements of compliance. The Franchise Committee has encouraged the active participation of its advisory members in the work of the Committee, which may serve as a forum through which franchisor and franchisee concerns are raised, discussed and acted upon.

The leading role the states took in liberalizing the earnings claim disclosures under UFOC Item 19 requirements is a clear example of how the states and the franchise community working together can accomplish streamlined regulation without sacrificing consumer protection. In a major new development at the state level, the NASAA membership in August of this year approved the Model Franchise Investment Act, a measure which will serve as a legislative blueprint for states interested in adopting new laws in this area. The Model Act is described in detail below.

Federal Regulation

The Federal Trade Commission (FTC) adopted its Franchise Rule in October 1979[17], a full eight years after the first state franchise statute was enacted.

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[17] Trade Rule 436, "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities Ventures" (16CFR, Ch. 1, Part 436). This Franchise Rule is intended to provide prospective franchisees with the information necessary to make informed decisions by requiring franchisors to disclose detailed information relating to 20 different aspects of the franchise offering. Information to be disclosed includes all relevant facts about the identify, location, business experience and financial background of the

The Franchise Rule was the result of ten years of proposals, comment and study of alternative approaches to federal regulation of franchising activity. Unlike most state laws, the federal Franchise Rule does not require that a franchisor file its disclosure document with the Commission, and consequently, there is no federal review of the disclosure document to determine compliance with the Rule's requirements.

The Franchise Rule expressly preserves state laws if they are equal to or more protective than the federal standard. The Rule does preempt state laws only to the extent that they are "**inconsistent**" with the federal standard. Note 2 to the Rule provides that a state law or regulation is not inconsistent with the Rule "**if the protection of such law or regulation afforded any prospective franchisee is equal to or greater than that provided by**" the Rule. State requirements that provide equal or greater protection, and therefore consistent with the Rule, "include laws or regulations which require the disclosure of more complete information to the franchisee." Thus, in those states with franchise registration or disclosure laws, franchisors are required to comply with both the FTC Rule and state requirements. By expressly recognizing the state's legitimate role in continuing to police the franchise arena and to so through regulatory measures that are even more protective of the public than the federal disclosure requirements, the Commission's present franchise rules have forged the framework for a cooperative and effective state-federal system of regulation.

The Guides to the Commission's Rule authorize franchisors to comply with the Rule's disclosure requirements by using disclosures either in the format prescribed by the Rule itself or the UFOC. As a result, franchisors doing business on a nationwide basis typically prepare their disclosure documents using the state-developed UFOC format, while the Commission's Franchise Rule disclosure format remains almost entirely ignored and unused.

In contrast with the broad state enforcement powers, the FTC's enforcement authority is limited to civil penalty actions and actions for damages on behalf of franchisees. In an eight year span, from the time of the Franchise Rule's inception in 1979 through 1987, the Commission brought a total of 15 enforcement actions -- 13 involving violations of the Franchise Rule and two involving misrepresentations by franchisors falling outside the scope of the

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franchisor, detailed descriptions of the franchise opportunity, including all initial and continuing fees and payments, and an explanation of all terms, obligations, conditions and requirements of the franchise agreement.

Rule. Since 1987, the agency has doubled its enforcement actions in this area, initiating 12 actions against franchisors under the Rule and bringing two additional actions against franchisors for non-Rule violations.[18]

Despite this somewhat more aggressive approach to policing the franchise marketplace, efforts of the Commission to adequately oversee the franchise marketplace are hampered by severely limited resources and a narrowly constructed mandate. The Commission's Fiscal 1990[19] entire budget request, which was intended to fund its two main functions of "maintaining competition" and "consumer protection," totalled less than $70 million. The Commission employs a staff of 923, down 53 percent from a high of 1,746 in 1979. It is difficult, although not impossible, to conceive of any further reductions in the Commission's already bare-bones staffing level. The Commission's budget for its entire "consumer protection" program is approximately $35 million, with a staff of 481. The Marketing Practices Division, which has jurisdiction over, among other time-demanding issues[20], the Franchise Rule, has a staff of just 65 and a budget that falls shy of $3.5 million.

Franchisees are further disadvantaged at the federal level by the absence of a legal right of action for franchisees or potential investors to sue for damages caused by violations of the Franchise Rule. The FTC has recognized that the private right of action is essential for effective enforcement and deterrence, but it has been consistently denied under the Rule by the federal courts.

FRANCHISE REGULATION IN THE 1990S: A LOOK AHEAD

State franchise regulation is an outgrowth of the legitimate state interest in protecting citizens from fraud and abuse in the marketplace. The system of franchise regulation now in place at the grassroots level is more comprehensive than that employed by the federal government and provides safeguards to consumers not currently available under the federal Franchise Rule. NASAA members also recognize, however, the need to continue efforts to update and modernize state requirements in response to a changing marketplace.

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[18] Franchising In The U.S. Economy, p. 25.

[19] "Federal Trade Commission, Fiscal Year 1990 Program Budget," transmitted by Chairman Daniel Oliver to Representative Neal Smith and Senator Ernest Hollings, January 9, 1989.

[20] In addition to its responsibility for ensuring compliance with the Franchise Rule, the Division of Marketing Practices oversees the Commission's efforts to combat fraudulent practices in the rapidly spreading epidemic of telemarketing scams; plays an active role in ensuring industry compliance with the standards set forth in the Magnuson-Moss Warranty Act; and monitors compliance with the Informal Dispute Settlement Rule.

The Model Franchise Investment Act

In March of 1988, NASAA appointed an ad hoc committee to discuss and draft model state franchise legislation. The goal of this effort was to provide model legislation for members of NASAA considering the adoption of franchise regulation. In July of that year, a draft of the Model Franchise Investment Act ("Model Act") was first released for public comment. In a departure from traditional state franchise laws, the Model Act was designed not only to regulate pre-sale activities of a franchisor, but also the "relationship" between a franchisor and franchisee after the offer and sale process.

Franchise fairness provisions first appeared in federal legislation in the Automobile Dealer Franchise Act of 1956. While there is no fairness regulation covering franchises generally at the federal level, a total of 17 states have adopted such legislation. Seven states[21] have enacted only franchise relationship statutes, while 10 "franchise regulation" states[22] have adopted relationship provisions either in conjunction with, or in addition to, franchise disclosure and registration statutes.

Issues commonly addressed in fairness laws and regulations include: (1) conditions permitting franchise termination and nonrenewal and minimum notification thereof; (2) prohibition of certain purchase requirements; (3) minimum requirements for the duration of franchise agreements; and (4) creation of a duty of franchisors upon termination of a franchise to repurchase certain equipment or reimburse a franchisee for some part of the value of the franchise.

The public comment period on the proposed Model Act closed on December 31, 1989, and a revised draft of the Act was issued for public comment in

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[21] Arkansas, Connecticut, Delaware, Mississippi, Missouri, Nebraska and New Jersey.

[22] California, Hawaii, Illinois, Indiana, Michigan, Minnesota, South Dakota, Virginia, Washington and Wisconsin.

February 1990. Given the level of interest, on the part of both franchisors and franchisees, in this issue, NASAA's Franchise and Business Opportunities Committee scheduled a public hearing for March 1-2, 1990, in Baltimore, Maryland. At that time, comments on the proposed Model Act were offered by franchisors, franchisees and members of the franchise bar. The Committee went back to the drawing board, and with its Advisory Committee, held drafting sessions in April and June. A final draft of the proposed Model Act was circulated in late June.

Given the controversial nature of the relationship provisions contained in the proposed Model Act, the Committee in its June draft of the Model Act deleted the relationship provisions. It was determined at that time that the Committee needed more time "to study this compelling issue, to gather more information to establish the need for such legislation, and draft fair and responsible legislation in this area."[23]

Key provisions of the Model Franchise Investment Act, as approved August 30, 1990, by the membership of NASAA, include:

- A definition covering franchising;
- Registration requirements, including the use of the UFOC as the disclosure document, thereby increasing uniformity;
- Exemptions from registration, but not from the anti-fraud and disclosure delivery requirements;
- Provisions covering the scope and applicability of state law;
- Deceptive and prohibited practices;
- Administrative enforcement provisions;
- Injunctive and criminal prosecution provisions;
- Private civil actions; and

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[23] See, "Notice of Request for Comments, Proposed Model Investment Franchise Act," North American Securities Administrators Association, With Revisions Dated June 15, 1990.

- Provisions allowing for cooperation with other agencies and organizations.

It is now expected that at least a half-dozen states will introduce the Model Franchise Investment Act in the 1991 legislative session.

State-Federal Cooperation

In adopting the Franchise Rule, the Federal Trade Commission explicitly endorsed a shared system of state-federal regulation of franchising. The state role in overseeing the burgeoning franchise marketplace is critical to the continued protection of consumers from fraudulent and abusive franchise promoters. NASAA respectfully submits that any attempts to reduce or eliminate the state regulation of franchising should be rejected because:

- The state franchise regulation system is more comprehensive than the system employed by the FTC and provides safeguards not available under the federal Franchise Rule;
- The FTC lacks, and is unlikely to be provided with, adequate resources to protect consumers from franchising fraud and abuse;
- There is no empirical evidence which suggests that legitimate franchising activity has been impeded as a result of state franchise regulation;
- Mechanisms are in place to resolve issues concerning uniformity among the several states; and
- States have a legitimate interest in protecting their citizens from fraud and abuse.

Given its limited resources, the FTC is severely restricted in its ability to investigate and prosecute Franchise Rule violations and, as is the case with most federal regulatory agencies, has tended to concentrate its efforts on cases where substantial losses or widespread fraud has been documented. As a result, state regulatory agencies shoulder the burden to investigate and prosecute the overwhelming majority of franchise fraud and abuse cases.

NASAA is encouraged that under the leadership of Chairwoman Janet Steiger, a new era of state-federal cooperation may be forged. We welcome the opportunity to foster increased uniformity and coordination with our federal counterparts. And, while uniform and streamlined franchise regulation will always be one our goals, we are mindful of our primary mission as state government officials, that is, protecting current and potential franchisees from fraud and abuse in the marketplace.

CONCLUSION

State and federal disclosure and registration requirements have substantially improved the general structuring of franchise offerings and have enhanced investor confidence in franchise opportunities. Demonstrably fair and honest franchisors have been successful under the existing system of franchise regulation. A 1988 report to the United States International Trade Commission concluded that: ". . . as evidenced by the growth of franchising, these laws [state and federal franchise laws] do not appear to have impeded growth; indeed, it has been suggested that these laws have helped eliminate or reduce potential abuses, and by doing so, instilled added confidence among prospective franchisees in the viability of the business in which they have invested."[24]

In fact, despite some claims to the contrary, there simply is no empirical evidence whatsoever that state regulation of franchising in any way impedes the development of that activity. What the statistics do suggest is that there is a direct correlation between the population of a state and the level of franchising activity carried out within that state -- irrespective of the franchise regulatory system. The predictions that franchising would in some way suffer in a regulated world are in no way borne out by the data of the federal Census Bureau and Department of Commerce.

We must now be more vigilant than ever in overseeing the franchise marketplace. As the prospects for a prolonged recessionary period grow, more and more corporate executives will be squeezed out of their jobs or forced to take early retirement. In addition, as the economy narrows, job opportunities in corporate America will shrink, turning more and more people toward other employment opportunities, including franchising. After all, what better way to turn a disappointment -- the loss of a job or no employment offers -- into a dream -- owning a business? A growing pool of former executives with money in their pockets will add fuel to the fires of the "dark side" of franchising.

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[24] Statement of Philip F. Zeidman and John M. Tifford (Brownstein, Zeidman and Schomer, Washington, D.C), December 30, 1988, before the United States International Trade Commission, "Service Sector Profiles and Barriers to Trade in Services -- An Investigation to Provide Information for Use by the United States Trade Representative in Connection with Trade Negotiations on Services in the Uruguay Round of Multinational Trade Negotiations," Investigation No. 332-257.

Mr. Chairman and Members of the Committee, we applaud your interest in exploring whether we have done all we can to safeguard the interests of investors and small businesspersons in franchise arrangements. The dramatic growth of franchising is an eloquent statement of its role in the U.S. economy. It has provided many entrepreneurs with the running start they needed to achieve success in the business world. But, we must be ever mindful that fraudulent and abusive operators have, for too many citizens, turned the American Dream into a nightmare.

We are hopeful that the publication of the Committee's report on franchising and this hearing will serve as the first steps in a systematic state-federal effort to gather the fuller universe of objective and empirical information that would allow for more precise evaluation of the changes that may be necessary in the franchise regulatory system. The lack of reliable federal data greatly complicates any effort to assess current laws and regulations. NASAA looks forward to working with you and your staffs as you move forward on this very important consumer protection effort.

Thank you.

TESTIMONY BEFORE THE HOUSE OF REPRESENTATIVES' SMALL BUSINESS COMMITTEE CONCERNING FRANCHISING IN THE U.S. ECONOMY

SEPTEMBER 27, 1990

by

RUPERT M. BARKOFF*

Franchising has been called many things. In the International Franchise Association's Franchise Opportunities Guide, it is called "the success story of the 1980's and 1990's."[1] In the House of Representatives' Small Business Committee's August 1990 report (the "Committee Report"),[2] it is noted that "[f]ranchising has been called the most dynamic business arrangement since the emergence of the corporation a century ago."[3] There is no doubt that there are many businesspersons in this country who owe their success to franchising.

There have been, however, many failures in the field of franchising as well. These often go unreported. In some instances, the failures have involved large established franchisors whose concepts have outlived their time. There are also cases of franchisors whose principals have committed outright fraud. Some franchisors have failed simply because of incompetence.

There have also been failures on the other side of the fence. Franchisees, too, fail for various reasons. Franchisees as well as franchisors can be incompetent, and this can be the source of failure. In many cases, they are undercapitalized. Sometimes the franchised concepts they have bought into are not competitive. And finally, franchisees fail because their franchisor--the person on whom they have banked their future--proves unable to deliver what it promised, or the franchisor's concept simply was not viable.

The whole topic of "Franchising in the U.S. Economy" deserves not a paper or a book, but a treatise, and hopefully a treatise will be the product of the hearings at which this testimony will be presented.

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[1] International Franchise Association, Franchise Opportunities Guide, p. 10 (Summer 1990).

[2] Committee on Small Business, House of Representatives, Franchising in the U.S. Economy: Prospects and Problems, 101st Congress, 2nd Session (August 1990) (the "Committee Report").

[3] Committee Report, at 1.

My contribution to this treatise will be devoted to two subjects: First, I will discuss, from a lawyer's perspective, the current regulatory environment for franchising, and second, I want to present my perception of some of the systemic problems caused by franchise agreements and the roles played by lawyers and the courts in the context of franchising.

As the Committee Report aptly points out, federal and state regulatory efforts can be divided into two areas: franchise sales regulation, and regulation that affects the franchise relationship. But before I discuss these topics, I want to preface my remarks with several caveats:

1. Franchise systems are readily comparable to delicate ecological systems. In many instances, it has taken years to create the proper balance necessary for both the franchisor and its franchisees to thrive, and any adjustment to the system, be it a change in concept, a change in management or ownership, a change in competitive circumstances or, and most importantly for purposes of these hearings, a change in the regulatory environment, can upset the system and cause irreversible damage.

2. Many of the observations presented in this paper are drawn almost exclusively from my seventeen years of private practice, twelve of which have been spent concentrating on franchise law. During that period, I have represented franchisee associations whose members own more than 10,000 franchised locations, over 100 individual franchisees, scores of start-up franchisors and several national franchisors with established franchise systems. I participated for several years as a member of the Industry Advisory Committee to the North American Securities Administrators Association ("NASAA"), and I served as liaison between the American Bar Association and the National Conference of Commissioners on Uniform State Laws ("NCCUSL") when NCCUSL undertook the drafting of its Uniform Franchise and Business Opportunities Act (the "Uniform Act").[4] I have been an active member of the American Bar Association's Forum on Franchising almost since its inception in 1977, and I have probably spoken with over 300 lawyers specializing in the field of franchising during my twelve years of practice in this specialty. My views, therefore, are based primarily on anecdotal knowledge, which I doubt is capable of more scientific substantiation under any circumstances. From these experiences, I have concluded that there are definitely problems in franchising, but it is difficult, if not impossible, for me to ascertain their magnitude and extent.

3. Trying to find solutions to the problems in franchising is complicated by the fact that franchising is not really an industry. It is a means of distributing products or services, which allows the party which has created these products or services to expand its distribution capacities by drawing upon the managerial capabilities and financial resources of others. Franchising can be useful in many industries, which makes regulatory efforts, especially in the relationship area, quite difficult. What might be appropriate legislation in the automotive industry may be totally inappropriate for fast-food restaurant chains.

4. One must be cautious when evaluating franchisors or franchisees as a group. Many franchisors are multi-billion dollar companies, whether measured on an asset or sales basis; others may have only $50,000 in net worth. On the other side, there are some franchisees, with investments in several different franchise systems, which may be larger than most, if not all, of the franchisors with whom they have contractual arrangements. I suspect, however, that many more franchisees fall within the mom-and-pop category. One phenomenon I have seen in the last few years is the prospective

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[4] National Conference of Commissioners on Uniform State Laws, Uniform Franchise and Business Opportunities Act, Bus. Fran. Guide (CCH) ¶3600 (1987).

franchisee who has been ejected from middle management in a large corporation and now wants to be his own boss, even if it means second-mortgaging the house to raise the capital required to purchase and open the franchise.

5. There are good franchisors and good franchisees, and there are bad franchisors and bad franchisees. When in college over two decades ago, one of my history professors often referred to a King Carl XII of Sweden who allegedly said that it was better that the innocent perish than the guilty survive. I hope in this country we subscribe to the opposite philosophy, and in crafting legislation or any other solutions to the problems in franchising, I urge the Committee to keep this in mind.

I. FRANCHISE SALES REGULATION: THE SEARCH FOR UNIFORMITY.

In the field of franchise sales regulation, I have been an advocate for several years of more uniformity and a strong critic of the current regulatory system. My views were comprehensively set forth in a paper delivered at the ABA Twelfth Annual Forum on Franchising in Toronto last year, and in the accompanying speech, a copy of which I have attached to this paper.[5] In my oral presentation, I concluded:

1. The current regulatory system was "not all that bad[, and e]ven with the FTC's . . . entry into the regulatory scheme in 1979, a somewhat happy medium has been reached."[6]

2. There is a definite lack of information on the deleterious effects the current regulatory system has on our economy.[7]

3. To date, the federal government has not devoted sufficient resources to protect franchisees who have been fraudulently induced into purchasing franchises.[8]

4. Most of the differences between the various state statutes and regulations do not truly further the interests of any state and in fact make the system unnecessarily complex, cumbersome and costly.[9]

5. There were significant structural, human and political barriers to achieving uniformity absent a complete or partial pre-emptive move by the federal government.[10]

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[5] Barkoff, "The Search For Uniformity in Franchise Sales Regulation: Don Quixote Rides Again," I ABA Twelfth Annual Forum on Franchising (1989), Tab 1; and Barkoff, "The Search For Uniformity in Franchise Sales Regulation: Don Quixote Rides Again" (unpublished speech, October 12, 1989) (hereinafter "Barkoff Speech").

[6] Barkoff Speech, at 2.

[7] Barkoff Speech, at 2.

[8] Barkoff Speech, at 8.

[9] Barkoff Speech, at 3.

[10] Barkoff Speech, at 4.

Most of my colleagues, I believe, are committed to the concept of full disclosure in franchise sales. Their major objection is to the current system which gives each registration state administrator (except in Michigan) the opportunity to review disclosure statements, to comment upon them and to mandate changes.[11]

NCCUSL's solution to this problem was to eliminate review altogether. In the Uniform Act, NCCUSL opted for a "notice" filing system, where the designated state administrator is advised that a particular franchisor will be offering its franchises for sale in that jurisdiction, but the disclosure statement is not subjected to any review process.[12]

Not surprisingly, NASAA was deeply troubled by NCCUSL's elimination of the review process. In its Model Act (the "Model Act"), which was approved by NASAA in August of this year, it retained the review process in full.[13]

The NCCUSL work product would have eliminated most of the concerns of my colleagues, including the problems caused by multiple reviews of disclosure statements. The Model Act does not, although it does address many of the other concerns expressed by the franchise bar. To date, the NCCUSL proposal has been introduced in two jurisdictions, Ohio and Colorado. It was quickly rejected in the latter, and, to my knowledge, the Uniform Act is still in committee before the Ohio legislature. Since the Model Act only received endorsement last month, we cannot yet tell how it will be received by state legislatures.

These two proposals for change both raised the specter of proliferating franchise sales regulation. Currently, franchise registrations or filings must be made in only 14 states.[14] The existence of the Uniform and the Model Acts, it was feared, might subtly suggest to legislators in other states that by not having franchise sales legislation, they were not adequately protecting their constituents. An even greater fear was that having decided that legislation would be necessary, legislators would cherry-pick either the Uniform Act or Model Act, or both, or go beyond the framework of either act and, in any event, create a cross-breed. This fear was enunciated in a resolution adopted by the American Bar Association in February 1988, when it endorsed the Uniform Act but appointed a task force to monitor the status of the Act's progress through state legislatures "for the purpose of considering whether NCCUSL's purposes are being achieved and, if not, whether ABA approval of the Act should be withdrawn."[15] Since the Model Act was not endorsed by NASAA until August 1990, the ABA has not yet had the opportunity to review the Model Act and to formulate a position. I predict that the American Bar Association's concerns regarding the Model Act will be the same ones voiced with respect to the Uniform Act, but that these concerns will be more vocal because of the Model Act's registration provisions.

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[11] See generally Garner, I Franchise and Distribution Law and Practice, §§5:26, 5:52-60 (1990) (hereinafter "Garner"); Sutherland, "The Risks and Exposures Associated with Franchise Noncompliance," 42 Business Lawyer 369 (February 1987).

[12] Uniform Act, §305.

[13] North American Securities Administrators Association, Inc., Model Franchise Investment Act §5 (June 15, 1980), Bus. Fran. Guide (CCH) (supplement, June 25, 1980) (the "Model Act"). The final version of the Model Act was not available at the time this testimony was finalized.

[14] See Garner, at §5:26.

[15] American Bar Association Section of Antitrust Law, Recommendation (February 1988), and Report to the House of Delegates (February 1988) (hereinafter the "ABA Antitrust Task Force Report").

All in all, I have no doubt that the current regulatory framework for franchise sales has inhibiting effects on small businesses and is causing economic misallocations of resources. I have had clients decide not to develop their concepts simply because they did not want to become entangled with the web of franchise regulation. I have had other clients restructure their distribution systems in order to avoid this web.

While my Toronto speech suggests that a full or partial federal pre-emption is the only way to achieve uniformity and thereby simplify the sales process,[16] pre-emption is not an alternative that should be considered lightly. The states' regulatory set-ups have played an important role in protecting franchisees, and I oppose tampering with state enforcement powers.

Nevertheless, it would behoove the states to find a solution to the multiple review problem--an issue that, from my vantage point, I have not seen the states willing to confront. One alternative would be to establish a central clearinghouse funded by all the states that require registration. The clearinghouse would have responsibility for performing all reviews, taking into account any peculiarities of state law. This would allow states to cut-back on the amount of resources dedicated to the review process, and eliminate the multiple review process. Perhaps some of these excess resources could be dedicated to enforcement. A clearinghouse would also afford an opportunity to improve the training of franchise examiners, and consequently the quality of each review.

II. REGULATION OF THE FRANCHISE RELATIONSHIP.

The only safe statements about franchise relationship regulation are that historically there has been bitter disagreement about what direction regulation should take, or, for that matter, whether regulation is necessary at all, and that the controversy over these issues is not likely to dissipate.

As the Committee Report correctly indicates, there is no uniformity or discernible pattern in franchise relationship regulation.[17] Only the automotive and petroleum industries are regulated at the federal level, and the regulatory approach in the two industries is quite different.[18] At the state level, there is a plethora of regulatory frameworks. In most states there are special industry statutes, with farm equipment dealers, wine and beer distributors and automotive dealers being the most commonly regulated.[19] In other states, there are statutes of more general applicability. Some of these regulate terminations,[20] some renewal rights[21] and some assignability.[22] There are also some states that regulate encroachment or freedom of association, among other matters.[23] Some of the relationship legislation is more procedural in nature,[24] while other statutes truly affect the substantive rights of the parties.[25] Looking at the existing regulatory pattern, there seems to be no consensus on which areas need government intervention, or the form of regulation.

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[16] Barkoff Speech, at 10.

[17] Committee Report, at 49-73.

[18] Rudnick, "The Franchise Relationship: A Look Back in Time," I ABA Eleventh Annual Forum on Franchising, Tab 5, at 14-15 (hereinafter "Rudnick").

[19] See Rudnick, at 14.

Unfortunately, much of this legislation and much of the discussion on franchise relationship issues are presented in bulk, when in fact there are significantly different regulatory approaches and policy considerations in each area. For that reason, my comments will be broken down to cover the specific issues.

A. Terminations. In traditional franchising, much of the outcry about franchisee rights has been overdramatized in the area of terminations. In dealership arrangements, it is not uncommon to find the arrangements terminable upon short notice, or perhaps with no advance notice at all. In franchise agreements, however, the so-called custom of the trade has been to establish fairly lengthy terms for the arrangement and to permit early termination by the franchisor only upon the occurrence of an event of default. In most circumstances, the franchisee is given a cure period, usually 5 to 30 days, in which to correct the default. There are some circumstances (bankruptcy, insolvency, unauthorized transfers of ownership and violation of public health laws) in which no cure period or an extremely short cure period (e.g., 24 hours) is customarily granted.

The legislative solutions with respect to terminations seem to follow the framework which is commonly found in franchise agreements. In California, for example, "good cause" is required for the franchisor to terminate the franchise agreement. Good cause is defined as including, but is not limited to, "the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure."[26] Under the California statute, notice need not be given in the case of bankruptcy, insolvency, abandonment, material misrepresentation in connection with the acquisition of the franchise, repeated violations, eminent domain seizures, the franchisee's conviction for a felony, or a determination by the franchisor that operation of the franchised business will result in an imminent danger to the public's health or safety.[27] Shorter cure periods are prescribed if the franchisee has failed to comply with applicable laws or failed to make timely payments of amounts due to the franchisor.[3]

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[20] See Rudnick, at 6-10; Pitegoff, "Franchise Relationship Laws: A Minefield for Franchisors," 45 Business Lawyer 289, 296-301 (November 1989) (hereinafter "Pitegoff").

[21] See Rudnick, at 6-10; Pitegoff, at 301-305.

[22] See Pitegoff, at 305-307.

[23] See Pitegoff, at 305, 329-331.

[24] See Pitegoff, at 299-301.

[25] See Pitegoff, at 301; see Wisconsin Fair Dealership Law, Wis. Stat. §135.03.

[26] Cal. Corp. Code §20020.

[27] Cal. Corp. Code §20021.

Termination legislation modeled on the California statute would not seem to add much to the rights of most franchisees. At the same time, legislation of this kind would not seem to adversely affect most franchise arrangements, but would afford protection to franchisees whose contractual protections against unjust terminations are less generous or non-existent.

B. Renewals. Again, unlike many distributorship agreements, most franchise agreements grant some form of extension rights to franchisees. These may take several forms. Some franchise rights may be renewed perpetually. Other franchise agreements may permit only one renewal, usually for a term not in excess of the initial term.

In my mind, the greatest problem with renewals is that the franchisee is often required to execute the then-current form of franchise agreement, which may contain terms substantially different from the terms of the original agreement. In this situation, can it be said that the franchise is "renewed?" In truth, a so-called renewal in these circumstances looks more like a first refusal to use the franchisor's system (whatever that might be) after the expiration of the current term. The mischaracterization of the extension rights granted to franchisees is a great source of controversy and misunderstanding.

There are meritorious issues on both sides of the renewal issue. The franchisor wants to maintain flexibility. It has developed a concept which in ten or twenty years may well be obsolete. That concept may well need updating. Updating could include new store designs, new marketing programs, and even new products or services. All of these may require additional financial commitments by the franchisee.

The franchisee typically does not focus on these problems at the time he purchases his franchise. Renewal may be one or two decades away. When renewal time comes, however, he may be faced with the need to make significant financial commitments to his business and, in many instances, to change his modus operandi in a way that will, at least in the short-term, reduce his profitability. When additional or increased financial commitments (such as royalty or advertising fees) are imposed, the franchisee may perceive that his bottom-line profit is deteriorating, while the franchisor's revenues are increasing. Often, in exchange for these additional financial burdens, the franchisee may find that there are no additional obligations imposed upon the franchisor. In fact, in addition to imposing more financial obligations on the franchisee, the renewal form of agreement may also impose more stringent legal obligations, and, at the same time, reduce the stated obligations of the franchisor. Was this what the franchisee envisioned when he bought his franchise one or two decades earlier?

The changing nature of the franchise at renewal time is only one of the problems in this arena. There are at least two others. The first is that if the franchisee elects to renew, there are usually several conditions imposed upon the franchisee in order for him to exercise the so-called renewal rights. The most troublesome of these is that the franchisor frequently requires the franchisee to execute a general release of claims against the franchisor. In the franchisor's mind, renewal presents a somewhat unique time to "wipe the slate clean." Franchising is a continuing relationship, and there is serious merit to the position that festering wounds will not prove healthy to this relationship. From the franchisee's perspective, a release of claims can place him in a serious bind. Either he must abandon the business he has been developing for some lengthy period, or he must give up significant claims. Again, there are merits in both perspectives.

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[3] Cal. Corp. Code §20021(e) and (j).

The second problem arises when the franchisee decides that the terms of renewal are too onerous, or for other reasons he decides not to renew. Virtually all franchise agreements contain a post-term covenant not to compete. This means that the franchisee must either shut down his business, sell it to a third party or change the business so that it would not be deemed competitive with the franchisor's system. Where the terms of renewal are not significantly different from the initial terms of the franchise, these restrictions do not necessarily seem unwarranted. Where renewal is not truly a "renewal" for the reasons discussed above, the non-compete seems excessively harsh. This is particularly true where the franchisee has made a significant capital investment--in a building for example--which may become unproductive if he must shut down operations. The excessively harsh nature of this restriction becomes more apparent if the franchisor has no immediate plans to re-enter the marketplace.

Unlike the situation in terminations, where legislation is procedurally oriented, renewal legislation to date has been somewhat scarce because most legislative proposals would severely affect the substantive rights of the parties, and state legislatures have shown a reluctance to enter this fray. The most famous (or, in some camps, "infamous") of the renewal statutes is found in Wisconsin.[29] The Wisconsin Fair Dealership Law provides that no franchisor may fail to renew or "substantially change the competitive circumstances" of a franchise agrement without good cause.[30] "Good cause" means either the failure to comply with essential and reasonable requirements of the franchisor which are non-discriminatorily imposed, or bad faith.[31] This statute, some argue, gives franchisees tenure. The issue that has not yet been resolved under this statute is what constitutes a "cancellation" or a "non-renewal." Would a substantial change of terms in a renewal agreement be permitted under this statute?[32]

The Illinois Franchise Disclosure Act[33] takes a considerably less radical approach to renewals. This act prohibits the franchisor from refusing to renew the franchise agreement without compensating the franchisee for the diminution in the value of his business if the agreement prohibits the franchisee from competing after the agreement expires or if the franchisee has not received six months' notice of the intended non-renewal.[34] Unfortunately, renewal is not defined in this act.

It is interesting that the initial drafts of both the Uniform Act and the Model Act contained relationship provisions covering non-renewals, among other issues, but that these provisions were dropped from both acts during the drafting process.[35] My perception is that these provisions were so sensitive that any attempt to reach consensus on the other provisions of these acts would have been torpedoed by the controversy over the relationship provisions, especially renewal. A similar controversy should be anticipated should the Committee conclude that further legislation in this area is needed.

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[29] Wisconsin Fair Dealership Law, Wis. Stat. §§135.01-.07 (1985).

[30] Wis. Stat. §135.03.

[31] Wis. Stat. §135.02 (4).

[32] This issue has not yet been resolved, but one case, Remus v. Amoco Oil Co., Bus. Fran. Guide (CCH) ¶8412 (E.D. Wis. 1985), could support the proposition that a non-discriminatory change in terms would be permitted under the statute.

[33] Ill. Rev. Stat. ch. 121-1/2 (1988).

[34] Ill. Rev. Stat. ch. 121-1/2, §20.

C. **Transfer.** In my practice, transfer issues have manifested the highest degree of friction between franchisors and franchisees. Typically, a franchise agreement will allow the franchisor the unfettered right to transfer its interest in the agreement to another party. In contrast, the franchise agreement will normally provide that the franchisor has granted the franchise to the franchisee in reliance upon his character, skills, financial resources and so forth, and accordingly, the franchisee may not transfer his interest without the franchisor's prior consent. The franchise agreement may then go on to provide that this consent will only be granted if certain conditions are met. It is these conditions which cause the friction.

One typical condition is that the transferee must meet the franchisor's approval. By the terms of the franchise agreement, this is usually a subjective determination, which means that the transferor is normally at the franchisor's mercy.

A second condition may be that the transferor must execute a general release of claims. The implications of this provision are similar to those present in the circumstances surrounding a renewal, as discussed above.

A third condition may be that the franchisor must approve the terms, including price, of the proposed transfer. Franchisors argue that if the price is too high, the new franchisee may not be able to meet his financial obligations. In at least one decision, a court has concluded that such a provision was not an unlawful restraint on trade.[36]

In short, the franchisee will be highly dependent upon the franchisor's good faith in order to get a transfer approved, but the motives of a franchisor in approving or not approving a transfer may not be all that clear. They may in fact be mixed. A franchisor clearly has a vested interest in assuring that the transferee will be qualified. If the transferor will no longer have a contractual relationship with the franchisor, then it is arguable that a release of claims is appropriate. And since the franchisor will have a vested interest in the new franchisee's success, the franchisor will not want purchase money debt burdening the operations of the transferee.

It has been my experience, however, that franchisors frequently abuse their discretion when it comes to transfers. Franchisors often view transfer as an opportunity to exert pressure on the franchisee or his successor. For example, the franchisor may view the existing franchisee's operations as substandard, and will therefore suggest, either outright or by implied threat, that a transfer will not be approved unless the operation is upgraded. If the transferor has multiple units, the franchisor might suggest that the transfer will not be approved unless the units retained by the franchisee are upgraded. I have also seen instances where it appears that the franchisor will drag its feet in approving a transfer in order to get the franchisee to sell the operation back to the franchisor, or to another favored person, sometimes at a more favorable price.

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[35] See Uniform Act, August 1985 Draft, §304; Model Act, §17.

[36] See Walner v. Baskin-Robbins Ice Cream Co., 514 F.Supp. 1028, Bus. Fran. Guide (CCH) ¶7723 (N.D. Tex. 1981).

From the franchisee's perspective, the problem is proof of motive. Transfers are normally subject to the franchisor's discretion, which in many instances must be reasonable, but sometimes may even be arbitrary, depending upon the terms of the franchise agreement. The burden of proof, should litigation ensue, will fall upon the transferor. Absent a smoking gun, litigation will be an uphill battle for this franchisee.

Unfortunately, there is little legislative precedent which sets any pattern for franchise transfers. The Arkansas Franchise Practices Act sets forth a procedural pattern in connection with franchise transfers.[37] The California Franchise Relations Act protects heirs, spouses and estates.[38]

My experiences, especially with franchise associations, suggest that the powers granted to franchisors to control transfers have extended beyond the legitimate interests of franchisors to protect the quality of their systems and warrants further investigation by the Committee. The extent of that abuse is not clear to me, nor is the appropriate remedy. One alternative would be a requirement of good faith and fair dealing. A second would be a requirement that the franchisor must bear the burden of proving the propriety of a refusal to transfer. A third alternative would be a prohibition against arbitrary decisions. A fourth alternative would be to create a set of procedures to be followed in the case of transfers. The most appropriate remedy to this problem cannot be ascertained until the parameters of the abuse are established.

D. Encroachment. Encroachment occurs when the franchisor directly or indirectly infringes upon the franchisee's rights to a particular customer, territory or product line.[39] Most franchise agreements are fairly specific in how they delineate what territorial, customer or product rights are granted.

In the case of territory, it is typical for a franchise agreement to designate a specified area or, alternatively, to specify that the franchisee may only operate from a designated location. In the latter case, the franchise agreement might also provide an acknowledgment by the franchisee that the franchisor is free to place additional units in any location he chooses, even though the additional units may adversely impact the franchisee's sales.

Where the franchise agreement designates a specific territory, the courts have had little difficulty in upholding the terms of the contract, absent extenuating circumstances.[40] If the franchisee has only been granted a specific location, the problem becomes considerably more complex, especially where an acknowledgment of the type described above is included in the franchise agreement. If the additional unit will substantially decrease sales at the initial unit so that the unit will become unprofitable, the franchisor may be accused of having acted in bad faith, notwithstanding the provisions of the franchise agreement.[41] Given current judicial attitudes,[42] it would not be surprising, even in this case, for a court to uphold the franchisor's right to open this additional unit.

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[37] Ark. Franchise Practices Act, Ark. Stat. Ann. §4-72-205 (1987).

[38] Cal. Corp. Code §20027.

[39] See generally Lowell, "Time Travel: Franchise Relationships of Tomorrow," I ABA Eleventh Annual Forum on Franchising, Tab 6 at 13 (1988); Barkoff and Averbook, "Market Penetration and Encroachment, ABA Seventh Annual Forum on Franchising, Tab 11 (1984).

[40] See, e.g., The Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480 (5th Cir. 1984); New York Motel Enterprise, Inc. v. Holiday Inns, Inc., 183 N.Y.L.J. No. 24 (Feb. 28, 1980, S. Ct. N.Y. County); Dayton Motels v. Holiday Inns, Inc., Case No. 74-1150 (Ct. Common Pleas, Montgomery Co., Ohio, July 29, 1977); Snyder v. Howard Johnson's Motor Lodges, Inc., 412 F.Supp. 724 (S.D. Ill. 1976).

Legislatively, encroachment has been left untouched for the most part. In the automotive industry, there are numerous state laws that establish procedures relating to the opening of new dealerships,[43] but there are few encroachment statutes of general applicability. The Indiana Deceptive Franchise Practices Act prohibits the franchisor from competing within the exclusive territory granted to the franchisee or, if no such territory has been designated, from competing "unfairly with the franchisee within a reasonable area."[44] The Washington Franchise Investment Protection Act has a similar rule where the franchise agreement designates an exclusive territory.[45]

My experience suggests that encroachment problems, like transfer problems, are quite common. Where the involved franchise agreement described a specific territory, the disputes have been fairly easy to resolve. Where franchisees have only received designated locations, the claimed encroachments can lead to nasty disputes, most of which tend to settle before they reach the point of litigation. A threat of encroachment can, however, be used to encourage a particular course of conduct from a franchisee.

I have observed what I will consider both good and bad trends in the encroachment area. Some franchisors have established internal, but nevertheless relatively impartial, procedures for making sure that additional units do not extensively harm existing units.[46] At the same time, I have seen more franchise agreements of late that are drafted along the lines set forth above, with the franchisee essentially waiving his right to contest the location of any additional units. Other franchise agreements I have reviewed recently are somewhat more subtle in that they may only grant "areas of primary responsibility," or they may designate a certain area as being protected, but allow the franchisor to decrease the territory if the franchisor determines "in good faith" that the existing unit is not adequately servicing the territory. The discretion granted to a franchisor in these circumstances is troubling.

E. Freedom of Association. Twelve years ago, franchisee associations were almost non-existent. In many chains, franchisees had no collective organization whatsoever; in others, franchisee

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[41] See Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir. 1979), cert. denied, 445 U.S. 917 (1980).

[42] See discussion in text accompanying notes 56-65, below.

[43] See, e.g., The Georgia Motor Vehicle Franchise Practices Act, O.C.G.A. §§10-1-620 through 623 (1983).

[44] Indiana Deceptive Franchise Practices Act, Ind. Code Ann. §23-2-2.7-2(4) (1987).

[45] Washington Franchise Investment Protection Act, Wash. Rev. Code §19.100.180 (1)(f) (1980).

[46] In the Holiday Inn chain, new unit locations used to be reviewed by a panel of franchisees. This practice raised significant antitrust problems. See American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3rd Cir. 1975).

"advisory councils" had been created. The advisory councils had no power per se, and were often comprised of franchisees hand-picked by the franchisor because of their general support for the franchise system or perhaps the franchisor. If this was not actually the case, then it was certainly a perception held by other franchisees.

In the mid-1980's, a trend toward independent franchisee associations became evident. Perhaps this was a function of the franchisees perceiving that an association might be their only source of protection. This trend might also have been aided by the franchisees' awareness of the success of these organizations in other franchise systems. Nevertheless, the maturation of franchisee associations has only slightly passed the incipient stage. To my knowledge, some large chains still do not have associations. Others, such as McDonald's, have what may be called "captive" associations in that they are funded by the franchisor and their agendas are strongly influenced by the franchisor, even though these groups have, and have demonstrated, some degree of independence at times. Franchisees of other large chains, such as Burger King and TCBY, have only recently formed independent associations.

In my work with associations, I am constantly told by franchisees that they fear the franchisor will retaliate against them because of their work with the association. I cannot say that I have ever been able to document such a case, but I do know that the fear runs rampant. I have also heard from other attorneys who represent associations that franchisors with whom they are working have at times threatened to crush the associations or otherwise discredit them.

To date, only nine states have enacted legislation to protect franchisee rights of association.[47] To my knowledge, there have been no cases brought to enforce these rights.

III. THE FRANCHISE AGREEMENT, THE LAWYERS AND THE COURTS.

As Part II of this testimony indicates, franchisors and their franchisees do not live in perfect harmony. Even though they have some shared objectives, there are some aspects of the franchise relationship that place them at odds. The most graphic of these are the financial aspects of the relationship. Franchisees are normally most interested in the bottom line. Franchisors, however, often make most, if not all, of their revenues from royalties or product sales. Whenever a franchisor adopts a new product line which may alter existing operations or otherwise cause the franchisee to incur capital expenditures, franchisees are suspicious of whether this program is designed to improve their, or the franchisor's, pocketbook.

A. The Role of the Franchise Agreement. The "peace treaty" between the franchisor and the franchisee is the franchise agreement. It forms the Magna Carta of the relationship. And the courts, particularly of late, have in effect elevated it to that level of importance.[48]

Like the Magna Carta, franchise agreements are documents in which one party surrenders power to the other. And in "olden days" (i.e., the 1960's), these documents, like the Magna Carta, were somewhat succinct. Today, the historical imbalance in these documents in favor of the franchisor still exists, but it has been exacerbated, as evidenced by the length these documents have now reached. One of my colleagues was recently quoted in the New York Times as saying that "the standard franchising contract he writes is now running 75 pages, triple the size of a few years ago, as franchisors frantically try to 'stay one step ahead of the jury' and cover all legal bases at signing time."* I found it ironically amusing when one of my partners, a well-known trademark attorney experienced in representing licensors in the field of trademark licensing, but somewhat removed in his practice from franchising problems, recently noted to me in passing that he had just read the franchise agreement of a national franchisor, and had forgotten how unbalanced these agreements could be.

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[47] Arkansas, California, Hawaii, Illinois, Michigan, Minnesota, Nebraska, New Jersey, Washington. See Pitegoff, at 329.

[48] See, e.g., Rosenberg v. The Pillsbury Co., 718 F.Supp. 1146, Bus. Fran. Guide (CCH) ¶9445 (S.D.N.Y. 1989).

I fear greatly that the situation has gotten out of hand, and I have been told by some of my colleagues who represent franchisors exclusively that they share this fear. As I have noted above, franchise agreements have always been skewed in the franchisor's favor. This is not unexpected since they are drafted by the franchisor's lawyer, but some of the "rights" granted to franchisors, or obligations imposed upon, or acknowledgments made by, franchisees have gone beyond reasonable limits. Some of the provisions I have seen lately have included:

- Listings of twenty or more events that could lead to termination (these were in addition to a provision that would allow the franchisor to terminate for "good cause");
- Liquidated damage provisions which, if the franchisee violates the post-term covenant not to compete, would require the franchisee to pay damages three times in excess of the royalty and other payments the franchisee would have paid had the franchise not been terminated;
- Jurisdictional provisions that would require the franchisee to litigate or arbitrate disputes in the county or state where the franchisor has its principal place of business;
- Arbitration clauses that prohibit the arbitrator from awarding punitive or consequential damages;
- A franchisor's right to arbitrarily refuse to approve a transfer;
- A release of all claims with respect to all franchises operated by the franchisee in order to obtain renewal or transfer approval of one unit;
- Non-competition clauses that would, in effect, prevent the franchisee from competing anywhere where the franchisor had established a company-owned or franchised unit;
- A minority shareholders' guarantee of a corporate franchisee's obligations under the franchise agreement, thereby limiting the franchisee's ability to attract capital;
- Prohibitions on the franchisee's right to "go public," thus restricting the franchisee's ability to raise capital;
- Limitations on spouses', children's and other family members' ability to engage in competitive businesses, even when they have no direct or indirect involvement in the franchised business; and

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*Deutsch, "Franchisees Fight Back," New York Times, Section 3, page 1, column 4 (December 4, 1988).

- Indemnification provisions that are drafted so broadly that they, when read literally, would require the franchisee to indemnify the franchisor for the franchisor's own gross negligence, wanton recklessness or intentional misconduct, not to mention ordinary negligence.

This list could go on endlessly.

At the same time that the list of burdens on the franchisee has been growing, the specified list of franchisor obligations has been shrinking. It is typical for a franchise agreement to specify in some detail what assistance the franchisor will give the franchisee in assisting the franchised business until opening day. There are very few obligations that are contractually imposed upon the franchisor past the point of opening. The expectations of franchisees, however, are that they will continue to receive support in their operations; that the franchisor will try to grow the chain; that the franchisor will develop marketing, advertising and promotional programs; and that the franchisor will police its company-owned and franchised units to assure that appropriate quality standards are maintained. Few, if any, of these expectations, are addressed in the typical franchise agreement in any meaningful way.

B. The Lawyer's Role in the Process. From the discussion in the preceding section, it is easy to see that the franchisor will be well-represented, legally speaking, in the franchise sales process. The preparation of a franchise agreement will require a significant commitment of management, legal and financial resources. Internal or outside counsel will also be involved in the preparation of the disclosure statements and filing applications which will be necessary to offer franchises for sale. The franchisor's expectation that it will sell hundreds of franchises warrants this type of investment.

The franchisee will normally be in a considerably different situation. While there are numerous large franchisees with capable in-house and outside counsel, I believe that the vast majority of prospective franchisees would fall in the mom-and-pop category. They certainly are not, for the most part, sophisticated, and in most cases lack the sophistication of the franchisor with whom they are contemplating a business relationship.

The prospective franchisee, I have found, also is less inclined, and has less incentive, to seek competent legal counsel to assist him in the transaction. This usually stems from a lack of understanding of the consequences of becoming a franchisee. He will view the franchise purchase in terms of "when he succeeds," and will not focus upon what happens if the franchise fails. He does not fully understand why it is significant that the franchisor can drastically change the deal at renewal time.[30] He will not focus upon the problems caused by an incompetent franchisor, or many of the other things that can go wrong despite the best intentions of the franchisor and franchisee. He is also frequently told that the franchise agreement is non-negotiable. In this light, it is not surprising that so many franchisees stumble into franchise relationships without seeking competent legal counsel in advance.

In those few cases where a prospective franchisee does consult a lawyer, the lawyer may find that he will not have the capacity to be effective. Sometimes the client brings in the documents after they have been signed. In other cases, the client advises his lawyer that he wants the best representation possible, as long as it does not cost more than $200.[51]. Needless to say, at prevailing rates, $200 will not go very far when the franchise agreement is over 50 pages in length and the corresponding disclosure statement is even longer. The lawyer may also be told that "the document is non-negotiable; therefore, don't spent much time in your review."

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[30] See Part II.B above.

The franchisee may also be hampered in finding competent legal counsel. Most attorneys are not familiar with franchising.[52] From a franchisee's perspective, there is not much "magic" in a franchise agreement,[53] but an attorney who is not familiar with an area will always be at somewhat of a disadvantage. He may not be familiar with customs in the trade or with what "normally happens." He will not be able to address competently such questions as "Is it likely that this contingency will occur and should I try to get that changed." When the franchisor asserts that a particular provision is non-negotiable, the attorney may not be able to respond effectively. In reviewing the offering circular, such an attorney, if not familiar with trademark law, will not be able to evaluate properly the section of the disclosure statement that covers this subject. The problem for the franchisee in securing competent counsel is also present when disputes arise and the franchisee seeks legal advice.[54]

While, through the efforts of the International Franchise Association, the ABA's Forum on Franchising and the realities of the market place, a substantial number of lawyers have become well acquainted with the law of franchising from the franchisor's perspective, there are few attorneys who have devoted a substantial portion of their practices to franchisee representation, and most of these are litigators. My informal polls and personal knowledge of the attorneys who practice in this field suggest that at least 80%, and probably more than 90%, of the attorneys who claim expertise in the field of franchise law consider themselves "franchisor lawyers." Given the lack of financial incentives in franchisee representation, this phenomenon will be difficult to correct.[55]

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[51] See Cannon, "Representing a Franchise," ABA Section of Business Law and General Practice Section Presentation at ABA Annual Meeting in Toronto, at 5 (unpublished, August 1988).

[52] The 2,000 members of the ABA Forum on Franchising comprise less than 1% of the ABA's entire membership, and less than 0.3% of all attorneys in the United States.

[53] Franchisor counsel must always worry, at a minimum, about the F.T.C. Rule (see note 62 below), state franchise registration and disclosure laws, state business opportunities laws and franchise relationship laws, federal antitrust and trademark laws and state laws relating to non-competition and the protection of confidential information and trade secrets. Knowledge of these areas is less important to franchisee counsel.

[54] Many lawyers are not interested in franchisee cases because, in today's environment, individual franchisee claims are difficult to prove, and, except in fraud cases, significant damage recoveries have been difficult to achieve. Franchisor-franchisee disputes are usually fact-sensitive cases, which makes them very messy and expensive to litigate. In many cases, franchisees are in weak financial positions to finance litigation because their primary source of income--their franchise--has not performed well. A "scorched earth" policy by a franchisor in opposing franchisee litigation can frequently be sufficient in itself to discourage franchisees from litigating or to encourage less than favorable settlements for the franchisee.

For the foregoing reasons, one might argue that the franchisee is more like a consumer than a businessperson, and it would not be inappropriate for franchise relationship regulation to be formulated on that basis.

C. The Judicial Philosophy Toward Franchising. Not surprisingly, the courts have viewed franchising in very traditional terms, which has meant that franchisees who decide to resort to litigation or are forced into litigation have entered the dispute disadvantaged by the provisions of their franchise agreements, and, more frequently than not, have come out bloodied. There is no empirical evidence that this is true, but the reported decisions of late have indicated that:

1. Antitrust law no longer affords a viable theory on which injured franchisees may proceed.[56]

2. The terms of the franchise agreement (which favor the franchisor, as described above) will usually determine the outcome of the litigation.[57]

Pages 54 through 62 of the Committee Report fairly accurately depict the development of legal theories that arise in franchise litigation. In the 1970's and prior years, the antitrust laws served as the basis for preventing franchisor abuse. Not only could this litigation be brought through class actions, but it held out the reward of treble damages and the recovery of attorneys' fees, should the franchisees prevail.

By 1980, the pendulum had swung in the other direction as antitrust law issues became less visible. I suspect that, in part, many franchisors cleaned up their acts. The switch in judicial and administrative philosophies certainly was also a major cause of this swing. Certain franchise attorneys at this juncture tried to establish the theory that the franchise relationship was a fiduciary one. The courts, however, were generally not willing to go that far.[58]

In light of the failure of the fiduciary theory, franchisee attorneys argued the applicability of the so-called covenant of good faith and fair dealing--that is, in every contractual relationship there is an obligation on all parties to act in good faith and to deal fairly with the other parties in their performance of the contract.[59] Some authorities have interpreted this to mean that neither party will take any actions that would deprive the other party of the reasonably expected benefits of the contract.[60]

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[55] See note 54 above. A recent phenomenon is that some lawyers who have traditionally been very "pro-franchisor" have become involved on the other side in some "big ticket" franchisee matters (i.e., in representing multi-unit franchisee or franchisee association representation).

[56] See Committee Report, at 8-11.

[57] See, e.g., the cases cited in note 40 above. See generally Rudnick, at 30-39, 55.

[58] See Rudnick, at 56-65; see generally Mazero, "Promises, Promises: Selected Common Law Contract Principles Related to Franchising," I ABA Twelfth Annual Forum on Franchising (1988), Tab 1.

This theory has had mixed success. A few courts have suggested that in their states there is no such covenant. When the franchise agreement does not expressly cover the question presented to the court, many courts have been willing to examine this covenant in rendering their decisions. When the issue before the court is expressly covered by the franchise agreement, courts generally have been reluctant to go beyond the four corners of the contract in reaching their decision.[61] Given the historical and increasing bias of franchise agreements toward franchisors, I doubt that this theory will level the playing field.

Many of the cases that come to my office, and I see this quite often in my work with franchisee associations, raise the question of what happens when the franchisor is incompetent. It is this issue that may be frustrating franchisees the most. Suppose, for example, that the franchisor introduces a new product, but fails to undertake any marketing prior to its introduction, and the product fails. The franchisee may have made significant investments (against his will) to bring this product on line. The franchisor has lost face, but the franchisee has lost hard dollars. Does the franchisee have any remedy?

Similarly, what liability will a franchisor have if his franchise is not, for the most part, economically viable? Under the FTC Rule, a franchisor is not required to make earnings claims.[62] Moreover, the franchisor's franchise agreement may expressly disclaim any implied warranties. What recourse should, and does, the franchisee have in this instance?

In a paper delivered in connection with the ABA Twelfth Annual Forum on Franchising in 1989, Mr. Robert T. Joseph, a partner in the Chicago firm of Sonnenschein, Carlin, Nash & Rosenthal, addressed the questions of whether a franchisor owes a duty of competence to its franchisees, and if so, would breach of that duty give rise to a claim by the franchisee against the franchisor, and would that claim be a tort claim or a contract claim.[63] Mr. Joseph observed:

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[59] See ABA Antitrust Task Force Report, at 3-12; Abrams, "The Implied Covenant of Good Faith and Fair Dealings in Franchise Relationships," I ABA Eleventh Annual Forum on Franchising (1988), Tab 2; Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith," 94 Harv. L. Rev. 369 (1980) (hereinafter "Burton"); Restatement (Second) of Contracts §205 (1979) and comment a.

[60] See, e.g., Burton, at 379.

[61] See ABA Antitrust Task Force Report, at 4-12 and related notes.

[62] The F.T.C. Franchise Rule is formally entitled "Disclosure Requirements and Prohibitions Concerning Franchises and Business Opportunity Ventures," 16 C.F.R. §436.1-3 (1979). Earnings claims are addressed at 16 C.F.R. §436.1(d) and (e).

[63] Joseph, "Do Franchisors Owe a Duty of Competence?," II ABA Twelfth Annual Forum on Franchising (1989), Tab 1 (hereinafter "Joseph").

> "A substantial portion of franchising jurisprudence has at least indirectly grappled with the extent to which the franchisor-franchisee relationship is more than a simple matter of contract."[42]

He concluded that, if there is a duty of competence:

> "it is best developed within the context and framework of the franchise agreement itself, interpreted in light of the language of the contract, the reasonable expectations of the parties, and, where appropriate, the course of dealing between the parties and customs of the particular industry in which the franchisor operates. If there are legitimate grievances about the ineptitude of franchisors, emerging and established contract law concepts should be an adequate basis upon which the franchisee can secure redress for injuries."[43]

It is my feeling that this is one of the critical issues that the Committee should address in these hearings, for it has been my observation that franchisees have been damaged by franchisor incompetence and that the courts have been unwilling to look beyond the contract in trying to grant appropriate relief. Should they do so? That is an issue the Committee ought to consider.

IV. CONCLUSION.

The Committee's inquiry into franchise regulation, both in the areas of sales disclosure and franchise relationships, is a timely one. We are currently encountering a changing economic environment. Domestic competition has increased, and the added factor of international competition means that we should make sure that our regulatory systems do not adversely and unnecessarily impair United States businesspersons, be they franchisors or franchisees.

In the area of franchise sales regulation, I am quite sure that regulation is hindering competition. In the area of franchise relationship regulation, I fear that regulation is not stifling competition, but there are troublesome forces at work below the surface. I am reminded of the opening scene of Shakespeare's MacBeth, where several witches, in the stealth of night, surround a boiling cauldron, and one of them recites the famous line, "Fair is foul, and foul is fair." I am not sure what these witches were cooking up, just as I am not sure what exactly is wrong in the area of franchise relationship law. But both my instincts and experiences suggest, in both cases, that something suspicious may be occurring.

I urge that the Committee review actively--but cautiously--the issue of how franchising is faring in the U.S. economy. It is important that the Committee remember that franchising, on the whole, has been quite successful, but that it also keep in mind that this success bears little comfort to those franchisees, be they few or many, who have been victims of unhappy marriages. To paraphrase Shakespeare's MacBeth, the Committee should "scotch the snake, not kill it."

I also would like to make an appeal to the franchise industry. For almost three decades, we have been posturing ourselves--looking selfishly and myopically at our own immediate interests--and not focusing upon the real objective--the furtherance of franchising. In my mind, the whole franchise sales area is in a mess, and it may well get worse, not better. Franchise relationship law is not in any better shape. Statutes like the Wisconsin Fair Dealership Law do not make sense, but they--and more state registration statutes--are the natural consequence of overreaching franchise agreements, which make franchisees more like employees than independent businessmen. Power plays by the franchisor do not help the situation, either. To quote the famous Bard one last time:

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[42] Joseph, at 82.

[43] Joseph, at 83.

> "[H]ave we eaten on the insane root
> That takes the reason prisoner?"

This may well be the case!

THE SEARCH FOR UNIFORMITY IN FRANCHISE SALES REGULATION: DON QUIXOTE RIDES AGAIN?

By

Rupert M. Barkoff
Kilpatrick & Cody

I am going to start today's presentation with a curve ball and spend a minute or two first discussing Spanish literature–specifically, Miguel de Cervantes' Don Quixote.

Don Quixote de la Mancha, you will recall, was a crazed old man who, having read too many novels about chivalry, decides to become a knight errant. He saddles up his saw-boned horse named Rocinante, puts on a rusty set of armor, and rides off into the Spanish countryside in search of romantic adventure, his main-squeeze Dulcinea and the opportunity to rectify a world full of evil.

The Don's travels, however, lead him through a series of misadventures, the most famous of which is his attack on a cluster of windmills, which he mistakes for evil giants. The results are, of course, inevitable, with Don Quixote taking a terrible beating–he is, at least for the moment, soundly defeated.

Now, what does this fable have to do with franchise regulation?

For nearly two decades, there has been a quest in the field of franchise sales regulation for uniformity. The question I would like to address this morning is whether by trying to bring uniformity to franchise sales regulation, we, the franchise bar, are collectively acting like Don Quixote–fighting a battle we cannot win, searching for a result we can never achieve. Are we, like our little cavalier, tilting at windmills?

This question is not easily answered. To understand its significance and complexity, we must first address two other questions.

First, why is uniformity important? And, second, what are the barriers to achieving uniformity?

The origins of this quest are interesting in that credit for the initiative to increase uniformity must be shared by the state regulators and industry. Most of you are familiar with the efforts in the early 1970's of the Midwest Securities Commissioners Association and its advisory committee to standardize the requirements of the various states that had enacted legislation regulating franchise sales disclosure. The Uniform

Franchise Offering Circular as we know it today, with only limited exceptions (in particular, Items 19 and 20), resulted from these negotiations.

It is interesting to observe that even 15 years ago, there was an instinctive consensus that something inherently good comes from uniformity. And it is important that each of you realize the magnitude of these early 1970's accomplishments. These pioneers in uniformity started with statutes that were distinctly different in important respects and with little empirical experience, and came up with a disclosure document and administrative system that has survived for almost two decades. For those of you who dabble in the securities area, compare the current regulatory situation in that field to the situation we face in franchising. Blue sky regulation pre-dates franchise sales disclosure laws by some thirty or forty years, but only recently has there been true progress in coordinating the states' regulatory efforts. In my mind, in two decades we have achieved more uniformity in franchise sales regulation than the securities industry has accomplished in half a century.

My point is that the current system is not all that bad. Even with the FTC's 1979 entry into the regulatory scheme in 1979, a somewhat happy medium has been reached. Why, then, should we ask for more uniformity?

Recently, a Task Force formed by the ABA's Section on Antitrust Law had to face this question in preparing comments to be submitted to the FTC. The comments were in response to the FTC's inquiry as to whether it should hold hearings on the issue of preemption in the field of franchise disclosure regulation. After some serious soul-searching about what were the "evils" of the current regulatory system, the Task Force finally concluded that the FTC should pursue these hearings not necessarily because preemption was desirable, but because the Task Force was not sure what deleterious effects the current regulatory system has on our economy.

We, as private practitioners, often lose sight of the fact that our bi-level government is based on the premise that states often have legitimate interests they are entitled to protect unless that protection violates our Constitution. The desire by the states to protect their citizens against franchise sales fraud certainly falls in this category. In this light, and given the fact that the system may not be seriously broken, can a credible argument be made to "fix" it, by whatever means that might entail? Is it, in other words, polite to fool with Mother Nature?

If we were convinced that legitimate state interests were fostered by existing differences in state franchise sales regulation, our inquiry would probably stop here. However, it is important for us and our state officials to reflect seriously upon what is positively accomplished by many of the differences that now prevent uniformity. These differences clearly result in definite costs being imposed upon franchisors. There are legal costs, management costs and intangible costs which are impossible to measure. For example, how many potential franchises never reached the marketplace out of fear of the regulatory scheme? Also, how many entities are there distributing their goods and services by less efficient means because of their fear of franchise regulation? Consider those issues carefully, and then look at the other side of the equation by asking the following questions:

- Why do California and Wisconsin have substantially different definitions for a franchise?
- What positive results are accomplished by having certain states require specific disclosures about state-peculiar laws?
- Is it really important that the Item 23 receipt be the very last page of the disclosure document, rather than being followed by the exhibit pages?

These are really the nickel and dime questions, for it is difficult to say that industry incurs substantial costs because of any of these state differences. But what many state regulators don't perceive is that there are more than one or two difficult-to-justify differences among the states, and when the resulting costs are totalled, first for a particular franchisor and then for franchisors generally, the magnitude of the expenditure takes on another character. Consider, too, that there is a governmental cost of maintaining a regulatory process that must allocate resources to address these problems.

Moreover, there are some cases where state differences can lead to more than minimal costs to a particular franchisor. The problem that most often comes to mind involves multi-level franchising, where a franchisor sets up a middleman who will have responsibility for selling his franchises, and then some responsibility for providing services. In some cases, the middleman will be a true subfranchisor; in other situations, he may be acting, as a matter of contract law, as a servicing agent. The situation becomes even more complex where there are multiple middlemen in a particular jurisdiction.

While the state franchise laws contemplate and address subfranchising arrangements, they do not adequately answer all of the questions raised by the number of permutations in these multi-level structures. For example: Who will be the registrant? Can multiple middlemen use one registration, or must each have his own even though the franchisor remains liable for performance of the promised services? Whose financial statements must be included in the disclosure statement? What happens if the franchisor is solvent but the middleman is not, or vice versa?

My experience in this situation is that the states will address these issues differently. You can imagine how surprised I was when I submitted my first multi-level franchise for filing in 1980, and most of the states came up with completely different solutions. Shortly thereafter, when serving on the industry advisory committee to the state regulatory officials, I had the opportunity to discuss this situation face to face with several of them at the same time, and I was surprised how little each state knew about the other's regulatory approach, both on this and other issues. In these discussions, I sensed little, if any, philosophical differences among the officials. Rather, the differences were more mechanical in nature. In the near-decade since this incident occurred, there has been little progress made in standardizing the regulatory approach to this particular problem, even though communications among the state officials have notably improved as a result of the efforts of NASAA–the North American Securities Administrators Association.

In fairness to the states, while I have some trouble isolating the state interests that justify state differences in most aspects of the regulatory process, I think there are some points where the regulatory schemes can differ with justification. Exemptions may fall into this category, as might escrow arrangements and certain enforcement aspects. But does the current scheme truly reflect carefully considered policy, or are we and our clients the victims of happenstance?

During the next two days, each of you can argue the merits of uniformity, or, more precisely, to what degree or in what areas uniformity is preferable. That question becomes academic, however, if in practice uniformity cannot be achieved.

In theory, uniformity is achievable. In practice, I have serious doubts, for there are many significant barriers to achieving this goal. These barriers are in part structural, but in many instances result from human and political factors. Let's look first at structural considerations.

The first structural barrier is that the state franchising statutes are not all alike; they are, in fact, notably different. The definition of franchise–the very threshold issue as to what will be regulated–differs among the states. Some states think in terms of regulating prescribed marketing plans. Others use the "continuity of interest" (whatever that means) test. In all registration states but Virginia, a "fee" must be paid by the franchisee. In Virginia, the fee requirement is absent, which means that most distributorships will be franchises, regardless of how they are labelled. How many manufacturers have fallen into this flytrap!

The statutory exemptions and exclusions are equally confusing, if not more so, and there are other areas where, when closely examined, the franchise statutes vary considerably–escrows, financial statement requirements, advertising, to name only a few. The technical differences among these statutes are covered in detail in my paper, and, therefore, I am not going to dwell on these in this presentation. But uniformity, I submit, cannot be achieved until these differences are eliminated. Given these differences, it is surprising how much uniformity we have been able to achieve!

Statutory differences are only the first structural barrier. Even if these could be eliminated, there is still the problem that states will promulgate different regulations. It is interesting to note that, at present, some states with very similar statutes have adopted dramatically different regulations. How can we avoid this problem? The answer to this question is further complicated, first, by the fact that the procedures for promulgating regulations may be governed by state administrative procedure acts, and, second, by the fact that franchise regulation falls within the securities commissioners' jurisdiction in most states, but under the attorney general's auspices in at least two jurisdictions.

These structural barriers are the easily curable part of the equation, as compared to the next set of problems, which I will categorize as the human factors. Whenever the human factor is introduced into the equation, different results can be expected. Administrators may, for example, have different priorities. Also, some will interpret similar statutes and regulations differently. The classic example of this phenomena can be seen in how states handle multi-level franchise registrations, as discussed above.

The examiners are also a significant source of the problem. They, too, will interpret their laws and regulations differently. Some examiners require stringent adherence to the UFOC guidelines. Others are more flexible. In some jurisdictions there are laws that may affect the franchise relationship, and the manner or extent to which these matters must be disclosed will depend in large measure on the examiner. Examiners will also have considerable say over what is material and how material facts will be disclosed.

Being human, examiners are also subject to the vagaries of life. They die; they get sick; they get fed up with their work. For various reasons, they move on or are not always available to service the franchise community. In one jurisdiction recently, the "department" quit, and the franchise registration process ground to a halt while the state looked for his replacement. The lack of continuity within the body of examiners is a serious problem in the registration process. How many times have we submitted a minimally changed application for renewal only to have questions raised because a new examiner has been put on the file? Not only are these situations frustrating, but they embarrass us in the eyes of our clients. The different degree of training examiners receive further contributes to the morass.

And, finally, keep in mind that the entire registration process can be viewed as a series of negotiations between our clients and the state. The franchise application is the first bid; the comment letters and responses are the counter-offers. In this environment, we can expect as much consistency in results as one would find in the pricing of goods in a Mexican market, or in a new car dealership.

Beyond the human barriers are the political barriers. These, too, are formidable in that they are so hard to control, and yet, absent such controls, uniformity will be difficult to achieve.

One set of political factors is financial. Some administrators are given budgets that permit them to hire and retain a sufficient number of professional examiners to discharge their departments' responsibilities. However, in too many jurisdictions, franchising has become the stepdaughter–a Cinderella, so to speak–to securities regulation. The revenues from registrations are graciously accepted, but the commitment to proper regulation is absent.

The second political factor is somewhat more murky. Based upon my conversations with many of you, I perceive a suspicion that the defensive posture which the state administrators seem to take is turf-protection. In many cases, I think we, the private franchise bar, are not being sensitive to state interests; however, I think our state officials are too quick to assume that the status quo is presumptively good. A critical question the FTC should consider in deciding whether to hold further hearings on the preemption issue is whether there is a lower incidence of franchise fraud in the registration states as compared to those states that have elected not to require registration. A careful study of the Michigan experience seems called for.

There is a third political barrier that I think needs to be taken into account–existing franchisees. At first blush, one might conclude that this interest group would not be an active player in the scramble for uniformity. Existing franchisees do buy additional franchises, and thus they do have a stake in the on-going process of protecting prospective franchisees. Franchisees also have a vested interest in seeing that other franchisees are brought into their system on a properly informed basis, so that they are less likely to bring suits based on their dissatisfaction at a later date. Notwithstanding these considerations, I suspect that the registration process is also viewed by franchisees as a chip in a poker game between franchisors and franchisees–a chip which the franchisees do not want to give up unless they are given something in return–possibly something in the areas of assignment, termination or renewal. If my hypothesis is correct, franchisor interests must identify what the price of franchisee support will be, and ask: Is the result worth the price?

To this point, I have intentionally ignored the role of the FTC in franchise sales regulation, and in so doing, I think I have nevertheless made a credible argument that uniformity, like Don Quixote's quest, is nothing more than a dream. When one considers the added complexities resulting from the FTC's presence in franchise sales regulation, the odds in favor of uniformity are exponentially decreased, absent a dramatic move by the Commission.

Given this background, are there any solutions to this predicament?

One approach would be to standardize state disclosure laws. The National Conference of Commissioners on Uniform State Laws (NCCUSL) tried to take this course, and even though they succeeded in adopting a Uniform Act in August 1987, the Uniform Act has been received with overwhelming apathy everywhere. Last winter, it was introduced before the Colorado legislature, but was soundly rejected in committee. The Uniform Act has now been introduced in Ohio, but the prospects of its enactment are remote. Even if the Uniform Act had been adopted in its pristine form in those jurisdictions, uniformity would not have been promoted, since neither Colorado nor

Ohio now regulates franchise sales. Rather, the situation would have become more complex–a fear expressed by the ABA when it gave only conditional approval to the Uniform Act in 1988. Also, is it likely that the Uniform Act will be adopted in any jurisdiction without significant amendments? Amendments, of course, would destroy uniformity.

I doubt that we will hear much about the Uniform Act, except in recognition of its role in the history of franchise sales regulation. The Uniform Act has no important backers. NASAA has opposed it because the Uniform Act, among other things, eliminates registration. The franchisee community opposes it because it does not forcibly address the issue of franchise relationship regulation. And the franchisor community opposes the Uniform Act because it is more likely to cause franchise sales regulation to be adopted in additional jurisdictions, rather than cause those states that currently regulate franchise sales to change their ways.

NASAA has also made a valiant attempt at uniformity by its recent introduction of its proposed Model Act. Given the scope of the matters covered by the Model Act–it covers both franchise sales and franchise relationships–I doubt that it will be enacted in more than one or two states, if anywhere. Unless adopted everywhere, it, too, will fail to promote uniformity.

A second solution would require a power play by the FTC--a further preemptive move. I say further preemption because the FTC has already partially preempted the states. In Note 2 to the FTC Rule, the FTC states that to the extent state registration laws afford less protection to prospective franchisees, those provisions are preempted. Thus, FTC preemption in this area is not without precedent.

Conceptually, federal preemption by the FTC (which could also be done legislatively by Congress) has considerable appeal. First, the FTC Rule does not require registration. It, therefore, eliminates many of the human barriers. Second, it is realistically the only true way uniformity can be achieved, for it would mandate the same disclosure rules for all jurisdictions.

But preemption to promote uniformity by eliminating state responsibility in franchise sales would be a coat of a different color from the preemption effected in 1979. It would subject the FTC to the criticism that it eliminated franchisee protection for the sake of promoting economic efficiency. This will be a tough ticket to sell, especially in light of so many decisions, such as the recent Haagen-Dazs case, which emphasize–some say over-emphasize–the importance of the franchise contract in establishing the franchise relationship.

Besides the conceptual objection to preemption which we could anticipate, there is also the question of how much preemption would be appropriate? The FTC, theoretically, could completely preempt the area, but even though I see a complete federal preemption as the only solution to uniformity, I am highly reluctant to say that complete preemption would be desirable.

First of all, could the FTC supervise escrow arrangements, or would escrows be eliminated altogether? The role of escrows is a second question the FTC should address in hearings.

Second, and more importantly, what about enforcement? The FTC has concentrated its limited resources on the "big" cases--where there is overwhelming evidence of wide-spread fraud. The states, on the other hand, have been able to reach out to more individual franchisees who have been defrauded by improper franchisor conduct. If the FTC preempts on the enforcement issue, is the federal government willing to provide funds to the FTC so that it could, in turn, provide more widespread enforcement? If not, then the FTC should leave the states with the power to rectify franchise fraud, even though different state enforcement policies may, in themselves, affect uniformity.

A third solution--a cross-breed--would be to create a federal registration process either through FTC preemption or by Congressional action. For reasons I am unaware of, the players do not like to talk about this possibility, but if one looks at the matter objectively, it has certain appeal:

- It could establish uniform parameters for which types of activities would be regulated; that is, what constitutes a "franchise."

- It would eliminate multiple reviews, which are probably the greatest obstacle to uniformity.

- Franchisors could still be required to make notice filings in jurisdictions where they intend to sell, thus providing states with the opportunity to monitor franchise sales, to require escrows and to protect their local citizens.

- Federal registration would permit states to shift their resources to enforcement, something which I think is badly needed. The states have been quick to crow about their active pre-sale enforcement efforts, but if one looks carefully at the enforcement actions brought to date, most, I suspect, have been clear-cut fraud causes, or those where the franchisor has simply failed to register. In several jurisdictions there is a reluctance to get involved in so-called private one-on-one disputes, even where there is clear-cut evidence that disclosure laws have been violated. This is particularly true where the franchisor has ceased to offer franchises for sale in that jurisdiction.

Given these three alternatives, are we likely to see uniformity in our lifetimes? Probably not.

Besides the barriers listed above, there is one further barrier, and that is the process of change itself. In order to effectuate change, under most scenarios all of the players in this game must be on board. This includes the FTC, NASAA, franchisors and existing franchisees. Is it realistic to expect this group to reach a consensus?

NASAA is a powerful and influential group and has legitimate state interests it wants to protect. It holds many of the cards in this poker game. If changes are to be made, it will be NASAA's ox that gets gored. Institutionally, NASAA can be a difficult group to work with effectively in order to achieve change. Its members have different opinions; and, in any event, it has no authority to bind its members. Moreover, the participants and leadership in NASAA turn over too frequently. In this decade, we have had at least five different chairpersons for its Franchise and Business Opportunities Committee, and as noted earlier, franchise sales regulation falls into the bailiwick of other non-securities-oriented governmental branches in at least two jurisdictions; thus, NASAA itself does not fully represent all state interests.

Franchisees have little incentive to promote uniformity, and while franchisees collectively have been unable to mount a credible campaign to change franchise law in their favor, they have considerable clout to protect the status quo. Remember that for each franchisor resident in a particular state, there will be thousands of franchisees.

Franchisors, I believe, would like to see uniformity, but the question is at what price?

And finally, where would the FTC figure into this poker game? Through preemption, it could eliminate many of the problems found in the current franchise disclosure system. Thus, if push came to shove, the FTC could hold all of the cards. But, given the Republican attitude toward expansion of regulation, and the monetary pressures hanging over the FTC, among other factors, and the complexities of the political process itself, it is doubtful whether the FTC can cash in on its cards.

There's a worn-out joke that may be appropriate at this point. Question: How many psychiatrists does it take to change a light bulb? Answer: Only one, but the light bulb must first decide it wants to be changed! Here, too, if the system will be changed, we must convince the appropriate parties that change will be good. It means that there must be some benefit for each of the constituent groups, and acceptance by all that not everyone will have his or her Christmas list filled.

Without trying to be overly dramatic, I feel that we are presently at the proverbial crossroads. The FTC hearings, should the FTC be so inclined, would provide a forum to determine what are, in fact and not in theory, the "costs" of our current system of regulation. What does experience tell us? In order to convince the constituents that change will generally be good, it is necessary to lay the required foundation. And, as the ABA Task Force concluded, I don't think this has yet been accomplished. If the conclusion is that change would be beneficial, then the question becomes change at what price?

Based on this presentation, I don't want you to think that I categorically and unquestionably favor preemption. I do not! At the same time, I am not satisfied with the present system. I would hypothesize that there are wastes and inefficiencies in the current system, with little corresponding benefits, but I believe we need to confirm this. If the hypothesis is confirmed, I believe that alternatives should then be actively considered. Unfortunately, if there is a serious regulatory problem, limited preemption seems to be the only realistic way out of the box.

True uniformity may not be achievable in our lifetime, but that does not mean that we should forsake the quest. One commentator in writing about Cervantes' Don Quixote concluded that he was a tragic figure–not because he failed, but because society could not accommodate a deviation from the norm.

For those of us who feel that uniformity is desirable, we should look in the mirror and realize that we, too, are Don Quixotes. Our end goal is probably an illusion. The status quo in franchise sales regulation–our society's norm–and the complex federal/state shared power environment in which we live–may be controlled by forces that are too overwhelming to deal with. But the appeal of Don Quixote was that he was an underdog who defied all odds, even though he was broken in his attempt. Learning from the tribulations of this sympathetic character, we should not abandon our search for uniformity even though we, too, face formidable barriers and risk the possibility of failure.

Falling short of achieving uniformity may nevertheless carry with it some success, and, at a minimum, the satisfaction that we have at least tried to tackle the problem. Thus, the search for uniformity, in whatever form, should continue to be our dream in the 90's.

STATEMENT OF

NEIL A. SIMON, ESQ.

SENIOR VICE PRESIDENT

INTERNATIONAL FRANCHISE ASSOCIATION

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SEPTEMBER 27, 1990

INTERNATIONAL FRANCHISE ASSOCIATION
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Introduction

Good morning, Chairman LaFalce and members of the House Committee on Small Business. My name is Neil Simon. I am Senior Vice President of the International Franchise Association (IFA), a trade association representing more than 650 business-format franchisors. IFA has served as the voice of the franchising community since 1960 and takes a special interest in laws and regulations affecting franchising. I welcome this opportunity to appear before you today.

Franchising in the Economy

The franchise method of distribution of goods and services is one of the most important forces behind the growth of small business in the U.S. economy. According to the report Franchising in the Economy 1988-1990, sales of goods and services in 1989 by franchising companies (product distribution franchisors and business-format franchisors combined) reached an estimated $678 billion through nearly 500,000 outlets employing more than 8 million persons in sixty different industries. More than one-third of all retail sales generated in the U.S. in 1989 were through some form of franchising. And while the economy grew by only 2 percent in 1989, sales by business-format franchisors increased nearly 8 percent and are expected to grow by 12 percent during the current year. Sales by business-format franchisors in 1990 are expected to total some $190 billion.

Two years ago, I testified before the House Small Business Subcommittee on Anti-Trust, Impact of Deregulation and Privatization, protesting the determination of the Office of Management and Budget to delete funding for the source of these figures of Franchising in the Economy. At the time, this comprehensive annual study had been conducted for the previous seventeen years and was the only report of its kind, public or private, available about franchising. The International Franchise Association urged OMB to reconsider its disapproval, but was not successful in its efforts. Subsequent to OMB's decision, IFA's Educational Foundation moved to fill the void. As a result, the study is now published by the accounting firm of Horwath International in conjunction with the IFA Educational Foundation. Horwath has taken over data gathering and analysis, adopting the methodology employed by the Commerce Department. The IFA shares this committee's concerns regarding the relative lack of information on the role of franchising in our economy and fully supports efforts to augment currently available data.

Business-Format Franchising vs. Product Distribution Franchising

State and federal authorities divide franchise relationships into two broad classes. The first class consists of product distribution arrangements, often called "dealerships," in which manufacturers sell to dealers finished products, such as automobiles and gasoline, for re-sale. These dealers are only loosely identified with the product manufacturers' corporate identity. The second class consists of "business-format" franchises which are characterized by a complete identification of the franchise with the franchisor and the licensing of a bundle of intellectual property rights revolving around the franchisor's trademark. In addition to adopting the franchisor's trade identity and image, these franchisees purchase a uniform system of business which provides that all units in the chain will operate in accordance with prescribed standardized procedures.

In contrast, dealership agreements, which are not regulated under the Federal Trade Commission Franchise Rule, are often unwritten and are generally of very short term -- far less than the fifteen and twenty-year terms typical of franchises. Unlike manufacturers whose dealers are primarily conduits for the sale of their products, the business-format franchisor's product is the franchise itself and its income is derived primarily from royalties. Inasmuch as royalties are based on the gross sales by the franchisee, the franchisor's profits are inextricably linked to its franchisee's health.

Franchises vs. Business Opportunities

Another distribution method which is commonly and erroneously referred to as a "franchise" are "business opportunities." This statutorily defined form of distribution is subject to specific regulation (primarily registration and disclosure) by the FTC and twenty-two states. Business opportunity regulations are intended to encompass arrangements such as rack jobbing, and vending machine distributorships.

The Franchise Agreement

The success of business-format franchising lies in its careful balance of business interests: franchisees remain independent business owners afforded an opportunity to enter a proven business and enjoy the advantages of being part of a larger system; franchisors build the strength of their trademark and image through growth unavailable by conventional means of expansion and receive royalty income from their franchisees as the system grows.

This arrangement is set out in the contract signed by the franchisor and franchisee which defines their respective rights and obligations. Franchisees pay to the franchisor an initial franchise fee and monthly royalties. In turn, the franchisor provides the means of retailing a unique product or service, which usually includes the use of its trademark, site selection, marketing strategy and plan, advertising, operating standards, quality control, a comprehensive operating manual and a system for regular communication with the franchisee for the duration of the agreement.

The terms of these contracts vary from one franchisor to the next according to the industry and business format of the franchise system. This flexibility allows franchise systems to meet the demands of the marketplace and compete with large vertically integrated chains. Members of the International Franchise Association are in sixty different industries and range from Hilton Hotels to Midas Muffler, from Century 21 Real Estate to McDonald's, from H&R

Block to Pearle Optical Centers, from Wendy's to Ziebart. Although these names may be familiar to you, the bulk of IFA's members are small businesses. Forty percent have fewer than twenty-five franchised outlets and 25 percent have less than 100 units. Each system is unique.

Franchise Relationships

The stability of the business-format franchise relationship is reflected in data regarding termination, nonrenewal and transfer activity. In the year 1988, according to Franchising in the Economy, 1988-1990:

- Of the 13,067 franchise agreements up for renewal, 11,713 or 90 percent were renewed; of those not renewed, 84 percent were at the initiative of the franchisee or by mutual consent;
- Of the 386,844 franchisee-owned outlets, only 2 percent were terminated. A clear majority of those contracts terminated were at the initiative of the franchisee;
- 96 percent of all franchisors offer franchisees a contractual right to renew their franchise agreements; and
- In 1986, the last year this data was made available by the U.S. Deptartment of Commerce, 98 percent of the franchisees that sought permission to sell their franchise (4,108 out of 4,202) were permitted to do so.

These statistics evidence the absence of abuse which might warrant additional regulation of the franchise relationship.

Franchisor/Franchisee Bargaining Power

Proposals to regulate franchise relationships are often based on a perceived inequality of bargaining power between franchisors and prospective franchisees. Nonetheless, it must be borne in mind that a franchisee's decision to enter into a franchise agreement is rarely due to necessity. Indeed, investors have hundreds of franchises from which to choose. If the terms of one agreement are unattractive, the prospective franchisee may look elsewhere or establish his or her own business. In any case, the real imbalance -- an informational disequilibrium -- is best redressed through disclosure law.

A franchisor generally invests considerable time, energy and capital with the goal of establishing a reliable reputation for its product or service. Indeed, a franchisor's trademark becomes inextricably tied to consumer expectation and becomes a valuable asset in its own right. A franchisee whose performance is below the standards set out in the franchise agreement reduces the value of the trademark as consumers will quickly associate the substandard franchisee's products or services with all outlets in the chain. Where a substandard franchisee is permitted to continue to use the franchisor's accumulated goodwill with the public, the consumer suffers and the investment of all other franchisees is directly impaired.

The primary method the franchisor has to protect the trademark, both for itself and for the benefit of the other franchisees, is to exercise its contractual right to rehabilitate the substandard operator, if possible, or sever its relationship in accordance with the terms of the franchise agreement. The power to terminate the franchise agreement in such situations is essential to the franchisor's ability to fulfill its contractual obligation to other franchisees of assuring reliability of product and services throughout its franchise system and to increase the value of the franchisees' investments.

As the figures discussed earlier indicate, franchise terminations occur extremely infrequently. A franchisor with cause to terminate generally provides the franchisee an opportunity to cure, not out of benevolence, but out of self-interest. A franchisor that terminates an experienced franchisee incurs substantial costs and cuts off the flow of royalty income from the franchise. Ultimately, the costs from such actions are substantial for all parties. As such, a franchisor has incentives to be fair if it wishes to retain its primary source of income -- its franchisees -- and, perhaps more importantly, to attract new ones.

In its 1986 report on a proposed uniform franchise act, the American Bar Association Franchise Committee Task Force stated that:

> It cannot be assumed that the bargaining power of franchisors in relation to franchisees is markedly tipped toward the franchisor in the broad range of industries in which franchising is used as a

> method of distribution. In some industries or markets, or in some franchise systems, franchisees may have considerably more bargaining power or sophistication than in others. Even assuming that imbalances in bargaining power may result in one-sided contract terms, there has been no demonstrable evidence of abusive activities (such as arbitrary terminations or nonrenewals or refusals to consent to transfers). Indeed, there are strong business incentives for franchisors not to engage in arbitrary or abusive behavior. They could incur substantial goodwill losses if they exploit the discretion afforded to them in their agreements, reducing the value of future franchises or dealerships and encouraging existing outlets to take steps to minimize potential losses in the event of similar treatment.

In other words, the system works. History has shown that the chance of success for a franchised business is significantly better than for other independently owned businesses. According to the U.S. Small Business Administration, nearly 65 percent of individual start-ups go out of business within the first five years of operation. By contrast, since 1971 less than 5 percent of franchised outlets have been discontinued each year. Legislative attempts to re-allocate the business risks inherent in the franchise relationship threatens the equilibrium of a franchise system and ultimately erodes the capabilities franchisees exploit through their investment.

Federal Franchise Regulation

A variety of laws have been enacted that are specifically designed to regulate business-format franchising. At the federal level, the Federal Trade Commission issued its Trade Regulation Rule on Franchising and Business Opportunity Ventures, 16 CFR 436.1, on October 21, 1979. It requires disclosure of specified categories of information to a prospective franchisee at the earlier of the first personal meeting for the purpose of discussing the sale of a franchise or ten business days prior to the execution of any franchise document or the payment of any money for the franchise.

The twenty-three categories of information to be furnished in the disclosure document include, but are not limited to: the business experience and background of the franchisor and its directors and officers; a litigation and bankruptcy history of the franchisor and its directors and officers; a description of the franchise business; the initial and recurring fees to be paid to the franchisor by the franchisee; the revenue that may be received by the franchisor from various sources; purchase and sale restrictions imposed on the franchisee; franchisor financing arrangements; termination and renewal terms; training programs; and financial information concerning the franchisor's financial condition for the three most recent fiscal years. Pursuant to a recent change to the disclosure requirements, franchisors must also provide the name, last-known address and phone number of each franchisee that has left the franchise system within the previous three years.

In addition to the disclosure document, the franchisor also must furnish a copy of the proposed franchise agreement and any other agreements to be signed by the prospective franchisee.

State Franchise Regulation

Prior to federal entry, several states had enacted legislation governing franchise disclosure. California adopted the first franchise law, effective January 1, 1971. Following this, fourteen other states enacted laws requiring registration and/or disclosure of information prior to the sale of franchises so that more than 40 percent of all investors come under the protection of some state law. With the exception of Michigan and Oregon, all of these states require the franchisor to register with the appropriate state administrator prior to the offer and sale of franchises.

This committee should note that until 1984 Michigan, too, was a registration state. However, under the leadership of Governor James Blanchard, a task force was assembled to determine whether the burdens and expenses of registration were justified in terms of their benefits. This task force, which included representatives of the state Attorney General's office, concluded that registration was unjustified, and legislation was passed converting Michigan into a so-called "notice filing" state. According to the director of the state's Commerce Department, "Many franchisors decided that doing business in the state was more trouble than it was worth and went to other states to market their business opportunities. With them went considerable job creation possibilities badly needly by Michigan's recession-ravaged economy." The wisdom of this action was reflected in the FTC's 1985 Impact Study of the Franchise Rule which was unable to find any evidence that franchisees -- the protected class -- benefit from the prior approval process.

The growing state regulation of the sale of franchises, with diverse and sometimes conflicting requirements, led to the adoption of the Uniform Franchise Offering Circular (UFOC) Guidelines by the North American Securities Administrators Association (NASAA). The UFOC requirements were intended to introduce a degree of uniformity into the disclosure required before a franchisor could seek to sell franchises under state statutes and regulation. However, since states interpret the UFOC requirements differently, and variation is imposed by statute, there remains a lamentable lack of uniformity. Although the UFOC ostensibly allows franchisors to use one document, twelve of the fourteen registration states require approval of specific disclosure language and some states reject language mandated by other states. The substantial cost of complying with this complicated patchwork of state laws makes entry by new franchisors extremely difficult.

In the early 1970s legislation was also adopted by states dealing with specific aspects of the franchise relationship. All but one of these franchise relationship laws were enacted prior to promulgation of the FTC Rule in 1978. While trade regulation has become accepted as an appropriate means of redressing narrowly defined abuse in specific industries, its application to business-format franchising is widely questioned. Business-format franchising is not, of course, an industry, but a method of distribution for a wide range of products and services. The greatest attribute of this method -- its adaptability -- is precisely what makes it unsuitable for across-the-board relationship regulation. The standards and practical necessities of one industry involved in franchising may easily be far too harsh or relaxed when applied to another industry utilizing franchising. This fact was fully appreciated by the National Conference of Commissioners on Uniform State Laws (NCCUSL), the source of the Uniform Commercial Code and other uniform laws, which spent five years preparing the first model franchise law (discussed below). In the course of their work, the Conference closely examined, and rejected, regulation of the franchise relationship. A comment to Section 201 of the model law illuminates the studied decision of the Conference:

> The Act relies on the duty of good faith rather than offering a code of prohibited or mandatory substantive actions or practices to govern the business relationship of parties to a franchise or business opportunity. More than two years of intense study and debate by the Drafting Committee, which considered several drafts that attempted to list prohibited and mandatory practices, led the NCCUSL to the conclusion that a list of prohibitions could not be expressed in a manner that was evenhanded, economically efficient, or responsive to the interests of consumers and of other franchisees or business opportunity operators. The NCCUSL also was

> concerned that the Act remain sufficiently flexible to be fair and appropriate over the enormous range of industrial sectors and geographic markets in which franchising is being employed.

A number of common law protections and state and federal statutes of general applicability also protect the rights and interests of franchisees. The common law of contracts, and in particular the implied duty of good faith and fair dealing, applies to contractual relationships to prohibit overreaching. Common law fraud concepts as well as state "Little FTC Acts," which are present in nearly all fifty states, also regulate and provide redress for these types of unfair and deceptive practices. Finally, federal anti-trust laws and the FTC Act also provide broad remedies for franchisor conduct which is anti-competitive or which constitutes unfair trade practices.

Instead of passing restrictive laws, states are now establishing programs to encourage franchising's growth within their borders. In Maryland, for example, IFA worked closely with the legislature and state officials to develop the nation's first program designed specifically to assist minority entrepreneurs interested in franchising. Similarly, the U.S. Department of Commerce Minority Enterprise Development Advisory Council (MEDAC) has identified franchising as an effective vehicle for increasing business ownership among minorities. MEDAC has sought out and received substantial assistance from the International Franchise Association in the development of a major program to provide recruitment, management, technical assistance, training and identification of capital sources for minority-owned businesses.

Conflicts Between Federal and State Regulation

It is well understood that overlapping federal and state regulation of an industry or business method can result in duplicative, inconsistent and costly regulation. The FTC anticipated this conflict by authorizing the use of a UFOC disclosure document to satisfy the disclosure requirements of the Rule. By so doing, the potential conflict between state and federal regulation was minimized. Unfortunately, since the adoption of the UFOC in the middle 1970s, progress toward genuine uniformity and improvement in state regulation of franchise sales has been painfully slow.

The principal difference between the Rule and state laws regulating offers and sales of franchises is the self-executing character of the Rule versus the administrative oversight by state administrators provided under most state laws. Proponents of registration contend that such oversight results in improved disclosure, arguing that intervention by administrators results in greater completeness and accuracy of disclosure. Nonetheless, respondents to the FTC's Impact Evaluation Study of persons who had purchased or considered the purchase of a franchise did not perceive disclosure statements available in registration states to be materially better than those available in other states.

The IFA and the overwhelming majority of franchisors firmly believe that presale disclosure of material information to prospective franchise buyers is essential to informed investment decisions. However, the incremental cost of state examination of offering circulars and franchise agreements to comply with variations in statute, regulation and administrative policy is, in many cases, an unproductive diversion of funds away from enforcement where it could more effectively protect prospective franchisees. To the extent this committee addresses the adequacy of current enforcement efforts, it might be noted that greater cooperation between the Federal Trade Commission and state enforcement agencies could yield benefits. Development of a state-linked database of federal franchise registrations could, for instance, relieve franchisors of the burden of multi-state registration and lead to a focusing of limited state and federal resources to eliminate fraud.

Conflicts Arising From Differences in State Law and Its Administration

Although franchisors attempt to use a uniform disclosure document in the registration states, franchisors are faced with divergent approaches to sales regulation, expressed in comment letters from state examiners which often require extensive changes in disclosure documents and franchise agreements before registration may be granted. New York, for instance, has never granted a registration in its ten-year history without issuing at least one comment or "deficiency" letter. Examiners base their comments on state franchise laws, regulations and administrative policies. However, comments are often based on widely varying standards of review and misinterpretation. States have had extensive turnover in examiners during recent years. The new examiners generally know little, if anything, about franchising and often registration files are "lost in the shuffle" as they pass from examiner to examiner.

This lack of uniformity and predictability substantially increases the time and cost of completing registrations, amendments and renewals. Some common registration compliance differences encountered by franchisors are summarized below.

- Minnesota and Indiana place limitations on the inclusion of mandatory arbitration provisions in franchise agreements.

- In Indiana, franchisors cannot place unlawful limits on litigation. This provision has been interpreted by the state to prohibit liquidated damages, a choice of governing law other than Indiana, or a consent to jurisdiction other than Indiana courts.

- North Dakota and South Dakota do not permit a choice of law of jurisdiction other than their own law and courts.

- Maryland and New York impose differing requirements regarding the information to be included under Item XX of the offering circular.

- Minnesota requires an affirmative statement to the effect that the franchisor will protect the franchisee's right to use the franchisor's trademarks.

- Virginia requires an estimate of annual costs incurred in operating the franchised business.

- Liquidated damage clauses must be deleted from the franchise agreement in South Dakota, Minnesota and Indiana.

- The Washington Franchise Protection Act sets forth rights a franchisee may have with respect to termination and nonrenewal which may supersede provisions contained in the franchise agreement. These statutory provisions must be set out verbatim in the offering circular and in the franchise agreement.

- Wisconsin offering circulars must state that the franchise agreement is subject to the requirements of the Wisconsin Fair Dealership Law.

- California, Indiana, North Dakota and South Dakota all require different disclosure concerning state-imposed limitations on enforceability of covenants not to compete.

Though by no means exhaustive, these state differences, many of which extend well beyond disclosure to require substantive modification of franchise agreements, indicate the extent to which a franchisor must modify agreements and offering circulars in the registration states.

State Regulation of Negotiated Changes

Franchisors are also subject to uncertain laws and policies on the subject of the negotiation of changes to franchise agreements. While no state franchise law expressly prohibits the negotiation of such changes, some state franchise law administrators have interpreted the disclosure laws of their states to prohibit the execution of franchise agreements on terms other than those reflected in the registered offering circular. This interpretation of state franchise law would require that no contract reflecting negotiated changes could be signed until a separate or amended registration has been approved which reflects the negotiated change. Given the frequent backlog of filings in administrative offices and the potential need to respond to state comments, a franchisor who seeks to amend its offering circular may have to suspend franchise offers and sales for several weeks or even months. This interpretation of state law has a substantial chilling effect on the willingness of many franchisors to consider changes to their standard franchise agreements.

The franchise statutes of two states (Illinois and Wisconsin) expressly allow a franchisor to agree to negotiated changes without going through the exercise of registration and re-disclosure, while another state (Virginia) permits a franchisee to void a franchise agreement if it was not permitted to negotiate with the franchisor on the terms of the agreement. In a recent court battle, a franchisor -- with IFA's assistance -- defeated the absolute prohibition against negotiations imposed by the New York Attorney General. The Attorney General has yet to publicly relent on its ban.

The wide divergence in state approaches to negotiated changes, many of which are the product of unwritten and changing interpretations and policies of state administrators, poses a difficult problem for franchisors confronted with reasonable requests for contract modifications or clarifications. The problem is compounded when there is overlapping state jurisdiction over a franchise sale. Because it is often impractical for a franchisor to adopt different policies on negotiated changes for prospective franchisees in different states, many franchisors choose a uniform policy of either refusing to negotiate contract changes or concluding transactions without first registering the negotiated changes. Prospective franchisees lose the benefit of negotiations under the former course, while franchisors that adopt the latter course incur a legal risk in some states, notwithstanding the benefit to the franchisee that sought the change.

The Price Of State Regulation

Compliance with state registration requirements adds substantially to the franchisor's costs of franchise sales. For larger companies, with an in-house staff of lawyers and legal assistants, such costs may be tolerable. For the overwhelming majority of franchisors that are small companies, the cost of compliance can be oppressive. It is not at all unusual for a franchisor to incur tens of thousands of dollars in annual expenses merely to keep state registrations current.

Delays inherent in registration due to backlogs in file reviews, responses to comment letters and challenges to examiner's rulings are costly to all franchisors. Franchisors must often suspend all sales activity while awaiting registration approval.

A company considering franchising as a method of expanding its business must evaluate various costs that will be incurred in developing and implementing a franchising program; many smaller prospective franchisors, perhaps the most potent source of successful small business development, are discouraged by confusing regulation and high up-front legal costs.

Overlapping Jurisdiction of State Laws

The breadth of the jurisdictional reach of state franchise registration and disclosure statutes presents yet another aspect of franchise sales regulation that can result in conflicting compliance burdens for franchisors. The sale of an area franchise can be regulated under several state franchise statutes, requiring the delivery of different state registered offering circulars disclosing potentially conflicting information (e.g., one offering circular containing an earnings claim and another stating that none are made). The unnecessary cost of complying with overlapping state regulation is obvious (e.g., otherwise unnecessary registration fees and legal costs, duplicating costs inherent in delivery of multiple offering circulars to prospective franchisees) and the prospective franchisee is often confused by receipt of disclosure statements that may differ in important respects. The confusion resulting from overlapping jurisdiction of state franchise laws would, of course, be lessened if franchisors were able to use a uniform disclosure statement in all states.

Most states regulate franchises offered or sold within or from the state. Several states regulate franchises offered or sold to their residents, without regard to where the transaction is negotiated or closed. Other states purport to regulate the offer and sale of an area franchise that provides for the establishment of franchised outlets within the state, even if the area franchisee is not domiciled within the state and no part of the transaction occurs there.

As an example, if a New York-based franchisor is selling a franchise to an Indiana resident for a business to be operated in Virginia and the franchisor and prospective franchisee meet in Baltimore where the franchisor makes an offer to sell the franchise, the franchisor is required to register in Virginia, Indiana, Maryland and New York, and must give the prospective franchisee the registered UFOC for each of the four states.

Uniformity and the Model Law

Concerns about this complicated regulatory climate have led to various attempts to promote uniformity and improvement in franchise regulation. After four years of debate and work, the National Conference of Commissioners on Uniform State Laws proposed the Uniform Franchise and Business Opportunities Act (Uniform Act) in 1987. The substantial efforts expended in developing the Uniform Act have thus far been unavailing; to date, the Uniform Act has not been adopted by a single state. The majority of states (which have no franchise laws) remain unconvinced that state regulation is necessary. Nor has the Uniform Act been followed in substantial part by any of those states that already regulate franchise sales, even though several of those states (e.g., Illinois) have undertaken significant reform of their franchise disclosure laws. Notwithstanding the efforts that it represents, the Uniform Act has found no champion in the franchising community.

NASAA has also made some efforts toward improving the disclosure available to prospective franchisees, notably through the revision of the guidelines for preparation of the UFOC with respect to earnings claims. That effort met with substantial success and provides a valuable lesson on the prerequisites for achieving a semblance of uniformity in franchise regulation. First, it addressed a specific problem area of disclosure. It had been recognized by franchisees, franchisors, and state administrators that earnings claim information is helpful, if not essential, to prospective franchisees, and that then-present disclosure rules discouraged many franchisors from furnishing this type of information. Second, because it was accomplished through disclosure guidelines that were part of the existing regulatory framework, revision of the UFOC Guidelines was sufficient in some states to effect a change in their earnings claim rules, and other states required only rulemaking proceedings. Finally, the state effort was endorsed by the FTC, which took prompt action to accept the revised UFOC as a means of compliance with requirements of the FTC Rule. The combination of these factors helped lead to a general change in the rules affecting earnings claims within a relatively short period of time.

In 1988, the FTC initiated proceedings to determine whether it should consider preemption of state disclosure requirements in order to achieve uniformity in regulation and avoid unnecessary compliance burdens on franchisors arising from the current pattern of franchise sales regulation. IFA initially took the position that the FTC should consider preemption of state regulation only if the states which regulate the franchise sales process proved unwilling to implement reasonable changes designed to reduce compliance burdens and otherwise improve the disclosure process.

Shortly after the expiration of the initial public comment period on the FTC's proposed rulemaking, NASAA revealed its Model Franchise Investment Act. There was no public discussion of the Model Act by NASAA or its members during the comment period on the FTC's proposed rulemaking. Issuance of the Model Act led IFA to request the FTC to reopen the public comment period. IFA's supplemental comments to the FTC expressed IFA's concern that, as drafted, the Model Act could create new problems for franchisors without resolving the problems that exist under current law. Fortunately, NASAA's Franchise Committee did meet with its Advisory Committee subsequent to the Act's release and portions of it were revised prior to its adoption in August 1990. Nonetheless, neither the need for registration -- nor the need for a model state law -- was ever discussed by NASAA. Inasmuch as NASAA's Franchise Committee does not, apparently, contemplate use of its Model Act by existing registration states, it is far from clear whether the Act will lead to greater uniformity or, exacerbate existing problems.

There are, however, positive developments -- including this committee's interest in franchising's contribution to the U.S. economy. Following years of discussion, NASAA's Franchise Committee is expected to release shortly a "state addendum" project which, in certain cases, will allow franchisors to use a uniform "core" disclosure document with state-specific addenda attached. In addition, the Federal Trade Commission has significantly increased its enforcement efforts.

Conclusion

It is clear that franchising is at a crossroads. Many issues are being re-opened for discussion. The International Franchise Association stands ready to play a constructive role in the formulation of sound public policy for business-format franchising.

At this time, I would be pleased to respond to the committee's questions.

STATEMENT OF

ROBERT L. PURVIN, JR., ESQ.

HEARING ON FRANCHISING IN THE U.S. ECONOMY
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

September 27, 1990

Mr. Chairman:

As a legal practitioner who has spent better than 17 years dealing with the day-in and day-out travails of franchisors and franchisees, I am most grateful to the Chairman and the Committee for extending me the special privilege of sharing observations, experience and frustrations borne from my career in Franchise Law.

Using the converse of one of the Bard's great speeches, I come in praise of an ingenious industry, not to bury it. My purpose is also to document serious problems which inhibit the franchising industry from achieving its fullest potential as an equitable mechanism for product and service distribution and capital formation, as well as an impetus for the entrepreneurial verve (with its speculative nature tempered) which has been the backbone of our economic culture for the past three centuries.

I like to think I offer the Committee a unique, balanced perspective. To my knowledge I am San Diego's only full time franchise attorney, and over the years my law practice has been equally divided between the representation of franchisors and franchisees. In 1973, I represented Carvel Ice Cream Company, one of the more notable names in franchise law, in what I believe was the first major litigation filed by former franchisees under the California Franchise Investment Act.

That same year I helped a pizza restauranteur terminate an unregistered franchise--this client later developed his own franchise system.

I have registered several companies to sell franchises in California and elsewhere, have served as general counsel to three companies with a multi-state presence, and I have exposure to all U.S. and Canadian jurisdictions which regulate franchise sales.

On the other hand, I have represented franchisees in numerous franchise acquisitions and termination disputes. I have represented several local franchisee associations, and have served as general counsel to a group of franchisees and former franchisees who are attempting to form a national organization called the American Association of Franchisees and Dealers.

Additionally, I have represented other forms of distributors and franchise hybrids--some of which I couldn't distinguish from a franchise for any practical purpose.

Although I haven't been visible at the national level, I have given more than a dozen seminars on franchising in San Diego, and have participated in local forums and publications on the subject.

I should note that my original interest in franchising emanated from an interest in capital formation. After receiving my Juris Doctor Degree from Georgetown University Law Center in 1972, I began my legal career with an emphasis on corporate finance, business planning and securities law. My early exposure to franchising fascinated me, as it still does, in its incredible potentials and attributes for low risk capital development. I was, and am, literally enthralled by franchising's unique and extraordinary facility for business expansion.

Although I am clearly a proponent of franchising as a powerful mechanism for growing and financing a business, in recent years I have become increasingly concerned over an enormous power vacuum whereby the economic and political strength of franchisors has totally dominated the legal, political and commercial aspects of the franchising industry. The marketplace is corrupted by the absolute power of franchisors. Mythical statistics are backed by governmental authority. Statutory and case law literally shield franchisors from the necessity of relevant disclosure, inhibit the ability for negotiation (even if economic market forces allowed it), and frequently deny franchisees any meaningful protection from abuse. The franchisor's unchallenged power is reminiscent of the great monopolists, trusts and cartels that arose in America at the beginning of this century.

I am a great believer in the marketplace, and I am confident that market corrections will bring balance to franchising and will restore an equitable system for both franchisors and franchisees. Overtime perhaps, like America's laborers during this century, franchisees will organize to overcome their economic imbalance, and market corrections will occur through balanced negotiation and legislation.

More probably, as with securities and antitrust regulation, the impetus for correction of systemic abuse will come from legislative enactment in accordance with free market public policies currently being thwarted by the unchecked power of franchisors. Certainly, short term legislative protections are necessary until needed market corrections are either enacted or evolved.

SOME GENERAL OBSERVATIONS.

In order to recommend change to the franchising industry, it is necessary to evaluate franchising as a whole--both the good and the bad. As this Congressional effort is meant to be a starting inquiry, perhaps a few basic observations are appropriate and useful.

Initially, I would like to commend the Committee's report on "Franchising in the U.S. Economy". Quite simply, the document is the best written and most complete statement on franchising I have ever read. The report is thorough, accurate and objective. More important, it is provocative in its description of issues and possible solutions. Indeed, if one wants to quickly come to grips with modern day franchising, I am aware of no better place to start than the committees report. I congratulate the committee for this excellent start.

So with the historical, political, commercial and practical aspects of U.S. Franchising already carefully laid out, I thought it useful to look back at the roots of franchising in the effort to preserve and improve its fundamental benefits.

Any sincere evaluation of franchising in the U.S. Economy must recognize one fundamental axiom: **Franchising is an entrepreneurial tool for effective business expansion.** The franchising process is an enormously effective system for many important industrial functions:

1. Product and service distribution;
2. Capital formation;
3. Vocational training;
4. Rapid business and system expansion;
5. Low risk, off balance sheet financing of both capital and labor improvements;
6. The effective recruitment of motivated, dedicated, "own-your-own-business-attitude" managers;
7. The packaging of intellectual properties and systems for exportability.
8. Generally, an effective design for business management for many industries requiring stable management at remote and varied locations.

The ability of franchisors to accomplish these important benefits through franchising has proven enormously beneficial to the U.S. economy, and to the dream of business ownership without the attendant risks of business start-ups.

Franchising promises to engender more and safer small business start-ups. Additionally, franchising creates exportability of intellectual properties. The franchise system actually becomes a new product for most franchisors (this has its bad side when franchisors lose sight of the primary goal of product or service distribution). Business format and product marketing systems are packaged in a franchise, protected by trademark registration and contract, and cloned for resale in multiple locations. Indeed, we are just seeing the beginning of America's new global export industry--franchised service businesses.

Clearly, no market adjustment of the franchising industry should curtail or diminish the attraction of franchising to accomplish these very positive benefits to our society. Rather the adjustments should be measured to insure that promised benefits are realized, and that those who buy into franchising have equitable opportunity and rights sufficient to keep franchising's attraction alive.

ATTRIBUTES AND ABUSES.

First and foremost, Franchising is a system of product and service distribution. From its beginnings to the present, franchising is primarily utilized for the purpose of distribution where quality and service identity with a trademark are critical to continued success of the product or service, and usually where local quality and service control is required. Franchisors' requirements for quality control and protection of legitimate intellectual properties are sacrosanct.

All too often, however, the "means" becomes the "end", and franchisors look at the franchise itself as their "product" and the franchisee as the "ultimate consumer." The franchisor forgets that the success of his franchisee is paramount to the success of the distribution system--to the continued expansion of product and service sales. I have represented companies that lived from franchise sale to franchise sale. Product sales were all but forgotten, and quality suffered. More importantly, the importance of qualified franchisees gave way to the need of cash to survive.

In my seminars on franchising, I constantly refer to "enlightened" franchisors as being companies that recognize profit and expansion rises and falls with the success of the franchisee. The "enlightened" franchisor understands that a superior franchisee provides start-up capital for business expansion, pays for his training, and has a vested interest in the success of the enterprise. Moreover, the franchisor is shielded from the performance of the franchise; the franchisor will earn its royalty whether or not the franchise is profitable.

Compared to internal expansion, where capital must be generated from the balance sheet, where employee training is a company expense, and where losses in one remote office can offset the performance of the entire company, the franchise alternative seems nothing short of miraculous. To profit from the actual sale of the franchise should be no more than icing on the cake--not the cake itself.

The committee is urged to recognize that the most successful franchise companies never lose sight of their "real" businesses--the products and services these companies sell to ultimate consumers. These companies never forget their "community of interest" with their franchisee distributors. Such franchisors have the reputation for supporting and nurturing their franchise systems, not for squeezing or intimidating them.

Capital formation, without stock dilution or encumbering assets, is the second major benefit of franchising. If a company can sell franchises it can raise capital even when investors or lenders are nowhere to be found. Moreover, capital raised through franchising is invariably non-recourse. Indeed, the person providing the capital also pays royalties for the privilege!

The trade-off, of course, is that the franchisee gets a divided piece of the franchisor's equity--a system and trademark license, an exclusive territory and profit rights from the franchisee's specific enterprise. However, if the franchisee's "equity" is illusory due the failure of the franchisor to support the franchise, or due to termination provisions which strip the franchise of capital value, the franchisee's investment can be worthless. Worse than a "Blue Sky" stock transaction, the franchisee may have years of investment and labor simply evaporate upon termination of the franchise. In the current climate whereby technical disclosure is more exculpatory than real, and balanced negotiation of franchise opportunities is rare, the franchisee's quid pro quo is frequently lacking.

Other benefits of franchising engender interesting observations:

1. Franchising tends to attract motivated and dedicated managers who pay for their own training, show up for work regularly, provide their own benefits and taxes, thus saving the franchisor from enormous financial burdens; nevertheless, franchisees are more "controlled" than most employees. Indeed, I have never seen an employment agreement as stringent as most franchise agreements.

2. Successful franchisees are usually better compensated than their employee manager counterparts. However, franchisees also incur risk of loss and have no assurance of a steady paycheck.

3. Franchisor's usually receive royalties or on going fees irrespective of the profitability of the franchise. As a result many franchisors lose concern for the profitability of their franchisees.

4. Both the franchisor and franchisee have a material investment in each franchise. Each usually claims the ownership of the goodwill associated with the franchisor's licensed trademark, and the relative rights of each claim are most difficult to decide. When franchises terminate, the rights to continue in business and to service the former franchisees' customers is perhaps the most difficult and controversial issue in the industry.

CENTRAL ISSUES IN FRANCHISING.

There are some consistent themes to the above observations about franchising. There are extraordinary benefits for companies who expand through franchising. The benefits to franchisees can be enticing when a franchise system is fair and "enlightened". The potential for abuse is substantial when a franchisor fails, for a variety of reasons, to appreciate the importance of the franchisees' success, and conducts the franchise system at the expense and detriment of the franchisees.

As the economic power of franchisors increase, the potential and incidence of abuse rises proportionately. Clearly, current trends in franchising demonstrate an enormous imbalance of economic power in favor of franchisors. To list a few indications:

1. Franchise agreements are increasingly one-sided, promising little but non-exclusive, location only licenses, and requiring adherence to system procedures which extend beyond most employee relationships.

2. Agreement provisions which strip terminated franchisees of the right to continue in their chosen businesses (under independent names), to forfeit rights to customers, and even the protection of their local laws.

3. A virtual lack of negotiation between franchisor and franchisee. Franchisors, often buoyed by statute as well as economic power, offer franchises on a take-it-or-leave-it basis.

4. Industry statistics, reported by the Department of Commerce, boast that only 5% percent of franchisees fail in their first seven years. The statistics reflect only those franchisors who chose to report, and fail to describe how many franchise owners may have failed in the same franchise

location which is continuously resold or replaced. Such statistics give a false image of franchising, but there is no organization or voice to question or challenge the voice of franchisors through the International Franchise Association.

5. Existing disclosure laws obviate the necessity to report the most meaningful data relative to franchisee earnings, and generally serve to exculpate franchisors who comply.

6. Frequently franchisees are unwilling to talk to prospective franchises for fear of franchisor intimidation, or, if they do talk they are less than candid because they don't want to compromise the resale value of their own business.

7. There is a crushing ability of franchisors to outspend franchisees in litigation and legislative activities. In my own practice, franchisor representation almost always means spare no expense; franchisees are almost always under extreme budgetary restraint.

The economic imbalance between franchisors and franchisees is not surprising; neither is it axiomatic. With an estimated 300,000 franchised businesses in existence, and probably an equal number of distributorships that closely resemble franchises, there is ample unbridled economic power to match franchisors. An organized franchisee association could do much to solve franchising's problems in the marketplace:

1. Establish and publish standards of fair franchising practices.

2. Accredit franchisors whose contracts comply with published standards.

3. Provide for research and educational efforts, in cooperation with the IFA or in opposition to it, to better understand franchising from the franchisee perspective.

4. Provide communication and legislative support so that pro-franchisee legislation has a voice in Congress and state legislatures.

Where independent franchisee associations have been established within a given franchise system ie., the Midas Dealers Association, they have proven successful in both achieving balance and equity within their systems, and in strengthening the reputation and value of the system as a whole. So far no one has successfully established and maintained a generic franchise association, though a few have tried and have failed for different reasons. Unfortunately, one reason for failure has been due to a certain selfishness on the part of existing franchisee associations who are afraid of losing control of their own destinies.

In the absence of a free-market solution to franchise abuses, legislative and regulatory efforts have attempted to foster fairness. The FTC rule and state franchise registration and disclosure statutes have attempted to discourage franchisor misrepresentation and provide civil and criminal penalties for franchisor abuses. More often than not, however, existing regulatory efforts regarding franchise sales have failed to protect franchisees, and have created enormous financial burdens for franchisors.

My franchisor clients with a multi-state presence face a never ending chain of registration and renewal. As most franchisors are constantly modifying their businesses, constant revision to disclosure statements is required.

Franchisors accept the expense of disclosure as a necessary evil, however, because disclosure provides exculpation from claims of misrepresentation. Since earnings claims are optional, and earnings data not required to be disclosed, franchisors continue to hide behind the disclosure laws and refuse to provide any earnings data at all.

Fairness statutes do provide some protection, although the California law can be avoided in part by the franchise agreement. However, only a few states have enacted franchise fairness statutes, which have been successfully opposed by the IFA as anti-franchising legislation in several jurisdictions. (See page 53 of the Committee report).

With a lack of legislative support, relief for franchisees has not generally been found in the courtroom. Decisional law in franchising has been inconsistent at best, but the trends suggest the following:

1. There is no private right of action for franchisees to enforce the FTC rule on franchising.

2. Although courts have described a "community of interest" between franchisors and franchisees, the courts have not provided any special duties arising from a franchising relationship. Indeed, courts have uniformly rejected the notion that a fiduciary relationship exists between franchisor and franchisee.

3. Courts routinely enforce arbitration and venue clauses which effectively deny franchisees their home forum, and often deny the application of protective legislation of the franchisee's jurisdiction.

4. Choice of law disputes almost always foster a spending war, with unpredictable results. Consequently, the enforceability of termination clauses, non-compete covenants, and the ownership of customer lists are frequently up for grabs.

Incidently, issues involving termination are probably the most difficult to tackle. Franchisors claim that goodwill should follow the trademark upon which customers have relied during the term of the franchise. Franchisees claim a right to deal with customers they have serviced and cultivated. Both claims have substantial merit, and it is difficult to make a clear rule. Probably each individual case should be decided upon its unique merits.

THE QUESTION OF SOLUTIONS

In my opinion, the longterm solution to franchise abuse must come from a balance of economic and negotiating power between franchisor and franchisee. While it would be preferable for the marketplace to make its own corrections, legislative impetus will probably be required. Only when franchisees are able to negotiate on an equal footing with franchisors will we see greater equity in franchise relationships. Only when the voice of franchisees musters significant political clout will we see balance in the legislature.

In the meantime, franchisors and franchisees alike can benefit from a new approach to franchise regulation. Registration, especially multi-state compliance, is an expensive burden to franchisors. On the other hand, state registration does have the public policy benefit of overseeing the quality of disclosure. Perhaps uniform pre-preemptive Federal standards of disclosure, coupled with states having concurrent jurisdiction over enforcement of the standards is a fair compromise. States would have the option to require registration as a mechanism to supervise compliance, but registration procedures should be standardized.

Most important to the franchisee is the creation of a private right of action to enforce the new franchising standards. Equally important is a Federal choice of law and venue requirement which preempts contrary provisions in franchise agreements. On balance, the forum of the franchisee should have precedence with respect to jurisdiction, venue and applicable law. The franchisor chooses to do business in the franchisees state, each state has a predominant interest in commerce transacted within its borders, and the franchisee is usually the least able to afford to defend or prosecute disputes far from home. All of these reasons would seem to favor franchisees in choice of law and jurisdiction questions.

Again, the most difficult issues to solve involve termination. The Committee's report raises the possibility of just compensation for the terminated franchise. The real issue is whether or not a terminated franchisee can continue to ply the trade he is trained for, and whether he can continue to service his customary clientele. Although paying a franchisee not to work or compete is probably not the franchisees' or the franchisors' choice, the suggestion is clearly in concert with prevailing law and custom which honors non-compete covenants upon the sale of goodwill. Indeed, in California where non-compete covenants are only valid in connection with the sale of goodwill, I always provide in franchise agreements that the Franchisor has an option to purchase the franchisee's goodwill so the non-compete covenant is enforceable. To command compensation where the Franchisor or franchisee is awarded the benefits of the goodwill from the franchise is but a small, logical step from existing voluntary practice.

CONCLUSION

It is interesting that in California franchisees derive their greatest protection, not from any franchising legislation, bu from the California Business and Professions Code which invalidates most non-compete covenants and provides most franchisees the right to stay in their chosen professions notwithstanding contrary provisions in the franchise agreements. It is also interesting that franchise termination fights are usually decided over such issues as who gets to compete, the phone number, the customers, and whose law applies.

Franchise legislation, to date, has not been effective in dealing with the central issues of franchising. Indeed, as I am accustomed to telling my franchisor and franchisee clients, "I have never written or read a franchise agreement I can recommend to a franchisee." The crucial issue in franchising is giving the franchisee the opportunity and economic muscle to negotiate fairness into franchise agreements. Until that time, it is incumbent upon Congress to continue the debate and to seek solutions which will foster fairness in the marketplace.

Thank you again, Mr. Chairman, for this opportunity to state my mind.

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October 11, 1990

John J. LaFalce, Chairman
Committee on Small Business
Congress of the United States
House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman LaFalce:

Once again, I would like to express my appreciation for the opportunity to testify before your Committee on September 27th. Beginning with the publication of the Committee's Report, and continuing through the hearings, I have had the sense, for the very first time, that Congress will begin the process of resolving serious abuses within the franchise industry which effect hundreds of thousands of small businessmen, and many billions of consumer dollars.

I have taken this opportunity to express my own view of the provisions of desired legislation. I will divide my comments into three categories:

1. Immediate measures to alleviate franchise abuse in the short term. Indeed, these immediate measures are most important measures for Congress to consider, even if nothing else is accomplished.

2. A proposed prescription for a greater federal role in franchise disclosure and registration.

3. Addressing the subject of promoting a competitive balance in the franchising industry, I will provide a rather surprising suggestion to encourage development of franchisee associations in the face of franchisor intimidation.

My written statement for the September 27th Hearing should provide substantial background to the proposals contained in this correspondence. Especially the materials contained in pages six through nine provide the underpinnings for most of the suggestions that follow.

I. Immediate Protections.

Notwithstanding many of the comments made by witnesses at the September 27th Hearing, the combination of the FTC Rule and the standards set forth in the UFOC do provide uniform disclosure standards of franchise law. These standards, however, flow from an FTC Rule whose authority was the original enabling act for the FTC. Courts have uniformly denied a private right of action to enforce the FTC Rule, because the underlying law failed to authorize a private right of action, such as contained in Section 10(b) of the Securities Exchange Act of 1934.

Accordingly, Federal legislation should specifically authorize the FTC to formulate its Rule on franchising, and should authorize a private right of action for material misrepresentations contained in disclosure statements and other statements. Congress would do well to model this private right on Section 10(b) of the Securities Exchange Act of 1934, or even better, by looking at the language of the Model Act proposed NASAA.

Perhaps even more important than a private right of action, Congress should deal with the forum selection issues which constitute the primary abuse of the franchise relationship. Any federal law should provide for jurisdiction and venue in the franchisee's local forum, and should mandate that the law of the franchisee's forum should apply in all respects to disputes between franchisor and franchisee, irrespective of any contrary provisions in the franchise agreement.

The creation of a private right of action under the federal disclosure rule, giving franchisees an inexpensive legal forum to resolve disputes, and allowing state law supremacy over the interest of its local franchisees, all would have an substantial impact on current franchising abuse. All of these provisions are contained in the Model Act, and I believe are contained in NCCUSL's proposed Uniform Act, so these measures should be able to win legislative approval without much difficulty.

In addition, it would be nice if federal legislation would improve the quality of existing disclosure. In my testimony for the Committee, I noted that existing disclosure is more exculpatory than protective. As with private offering circulars in securities law, franchisors look at disclosure statements as insurance policies to protect against fraud claims even though franchisors are aware that most franchisees do not read or understand the complicated language provided in the franchisor disclosure statements. Moreover, to the extent that disclosure is utilized to protect franchisees, existing disclosure fails to provide the most meaningful data for a franchisee to make an informed decision. Three new areas of disclosure are suggested (and others perhaps may be needed):

1. There should be a requirement that franchisors concisely state all services which they are obligated to provide pursuant to the franchise agreement.

2. If earnings claims continue to be optional, earnings and sales data should absolutely be made available to every franchisee. Currently, there is no requirement for a franchisor to either provide sales data for the average franchise unit or earnings claim in their franchise offering claim.

3. Unlike the requirements of all securities offerings, there is no requirement of franchisors to state the relevant risks of entering a franchise business. Making a franchisor disclose all the risk factors associated with a franchise business would, as in securities law, put the onus on the franchisor to smoke out and disclose relevant risks in the specific industry.

Finally, the special relationship between franchisor and franchisee should be defined, the "community of interest" as courts have called it. Congress could establish mutual duties arising from this relationship, and establish private rights of action for abridgment of these duties.

II. Federal Role in Franchise Disclosure and Registration Practices.

As I stated in my testimony, I, for one, am less enthralled with franchisee registration as a mechanism for franchisee protection as some of the other witnesses to appear before your Committee. Registration constitutes an enormous financial burden for franchisors and an enormous financial burden for the states which enforce registration. Registration does promote superior disclosure by franchisors, but the economic benefits may not merit the added expense. Registration of franchise sales is an ongoing process requiring constant updating for each jurisdiction which requires registration. It is not uncommon for a franchisor to incur legal bills of $20,000 to $30,000 a year for maintenance requirements if registered in all thirteen registration states.

It is my personal view that relief from registration burden may be an equitable trade-off to franchisors for their acceptance of some of the pro-franchisee provisions recommended above. In any event, the disclosure and registration process needs to be more standardized and more cost effective.

One partial solution to the disclosure dilemma is by a federal mandate authorizing negotiation of franchise agreements. Ideally, the offer to sell a franchise as set forth in a franchise document is just that: an unconditional offer which may be accepted intact, or may be subject to a franchisee's counter offer. Both California and New York take the position that the actual final form of agreement must be registered with the state as accepted. Clearly this stifles negotiation, and when negotiation does occur, it complicates the registration process.

My specific recommendation in the registration area, given the political concerns of the states, franchisees and franchisors is as follows:

1. Disclosure should be federally mandated and uniform for all jurisdictions. This can be deferred to the FTC or an organization like NASAA which has already promulgated the UFOC.

2. States should be allowed to have current jurisdiction over enforcement of disclosure rules. States may elect to require registration, or simple or complex notice requirements such as already exist. It is my personal view that most states will either opt to provide notice requirements when franchisors come into their states, or will opt for no registration beyond the federal rule. This should alleviate extraordinary financial burdens on franchisors. Private rights of action and choice of forum protections which preempt contractual franchise contract provisions will provide the self-executing force to provide a meaningful remedy for franchisees.

This type of proposal should be acceptable to the state regulators who want to preserve their own registration systems and want to continue to regulate franchising within their borders. Franchisors should apply for the substantial savings in compliance costs, and may accept these savings as a fair trade-off for the self-help provisions to protect franchisees.

II. Long Term Provisions to Promote Franchisee Associations.

As I have emphasized in my oral and written testimony, the ultimate solution to the imbalance of power in franchising is to achieve a balance where franchisees can meet franchisors on an equal plane in the marketplace. A private franchisee association serving the interests of the general body of franchisees, much as the IFA serves franchisors, will provide balance in franchisor practices, the ability for *macro* negotiation of franchise agreements, and, the development of reliable statistics which effectively test the data provided from the IFA.

Efforts to develop generic franchisee associations have been uniformly unsuccessful to date. Franchisees have feared joining such associations, and franchisee associations of specific industries, though successful, have failed to support generic associations due to issues of self-interest. The only way to encourage franchisee associations is through economic incentives.

Perhaps with various tax incentives, of even a minor nature, franchisees will understand that a modest investment in a franchise association is in his best economic interest. For example, the American Association of Franchisees and Dealers calculated there were approximately 500,000 franchisees, and perhaps an equal number of distributors in the United States. If six percent of the available pool of franchisees and distributors would invest $100 per year in association dues, franchisees could effectively match the $6,000,000 annual budget of the IFA which claims is sixty percent participation rate amongst the business format franchisors.

Accordingly, a $100 per year tax credit for franchise association dues paid (from an approved list) would seemingly provide substantial incentive to franchisees to associate. Incidentally, the tax incentive could phase out over a two to five year period, because once franchisees join the organization, the association benefit should be self-apparent. It is also my belief that stimulating the marketplace to solve the abuses of franchising should obviate the later necessity for greater franchise regulation, and therefore insure that additional federal appropriations (that could be far more expensive than the cost of the tax incentives in the first instance) would not be necessary.

I hope some of these suggestions are beneficial to you in formulating your legislative initiatives. If I can be of any assistance to the Committee with further comment, I would greatly appreciate the opportunity.

Very truly yours,

BROWN, MARTIN, HALLER & McCLAIN

Robert L. Purvin, Jr.

RLPjr/hla
cc: Dean Sagar

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Kansas City, Missouri 64111
(816) 753-6900

September 11, 1990

The Honorable Ike Skelton
2134 Rayburn Building
Washington D.C. 20515

Re: Regulation of Franchising

Dear Mr. Skelton:

Alan Wheat is technically my representative, but I am addressing this correspondence to you because you serve on the Committee on Small Business and I believe your committee may be considering new federal regulation of franchising.

Although I serve as a corporate attorney and my views have developed from that perspective, the remarks contained herein reflect only my own opinion and are not submitted on behalf of my employer. I hope that they will be considered from the beginning if Congress should consider new legislation.

The committee is, of course, eventually likely to receive comments from interested groups.

One of those is North American Securities Administrators Association, which so far as I can tell is simply a self-appointed group of state regulators acting as though it has authority to speak on behalf of others, ostensibly for purposes other than perpetuating the regulators' own employment positions. State regulatory groups are normally adversarial to franchisors and most of their agendas include levying charges against franchisors for each "service" they elect to provide. Those regulating states seem to have their own nitpickers to demonstrate that their fees are "earned" by the party inspecting an application. The Alberta Securities Commission, which, of course, is not under the jurisdiction of the U.S. Congress, is so rank as to provide a first response indicating a date by which an applicant should expect to receive an initial deficiency letter. A highlighted copy of their response is attached for your inspection. At least the Alberta Securities Commission makes no attempt to conceal its distaste for franchisors.

The American Bar Association and lawyers in private practice will, of course, applaud any additional regulation, regardless of content, because it will generate additional fees for lawyers.

Corporate attorneys are more likely to view additional regulation as diverting their limited time to addressing superfluous statutes.

The International Franchise Association might be expected to comment but has been somewhat lackadaisical to date in presenting the franchisor's position on many issues.

The National Conference of Commissioners on Uniform State Laws would present the most independent and detached view. It is not in a position to profit from any regulation and so would not offer any self-serving ideas. However, because it has nothing to gain, I would not expect it to devote any inordinate amount of effort to persuade Congress to adopt a neutral viewpoint.

I do believe some minimal regulation of franchising is necessary to eliminate or reduce the potential for abuse of the interests of franchisees. I consider my own employer to be an honest franchisor and most other franchisors who have been in the industry for several years to be honest; and honest franchisors need franchisees as partners with whom they can work to build the business and profits of each. However, there are exceptions and those exceptions make regulation necessary. Some dishonest franchisors foresee potential franchisees as plums to be plucked by imposing inordinate initial franchise fees or by unreasonably terminating franchises and appropriating their goodwill.

My first suggestion would be that any new federal statute totally preempt state laws relating to all aspects of franchise disclosure and regulation. There is no point in fifteen states burdening interstate commerce by having slightly different laws regulating franchising. The problem, of course, is that regulators in those states are entrenched in positions which they strive to maintain and so would advocate that, for some plausible excuse, their functions should be continued.

Current legislative and regulatory efforts tend to reflect only franchisee concerns, but, just as there are unscrupulous franchisors, there are unscrupulous franchisees. I would hope that any new regulations would be bilateral and address contract performance in the same way that they address termination and non-renewal. For instance, many franchise agreements require a franchisee to pay a royalty based on sales. Where the sales are of a service, the opportunities for franchisees to underreport their sales and pocket a few hundred or thousand dollars in royalties are rampant, yet no franchise regulation of which I am aware has ever provided that underreporting of sales on which royalties in excess of $100 are required to be paid would constitute a crime.

With respect to termination, obviously franchisees who are successful at building a business should not have their franchises terminated arbitrarily without very good cause. The problems for honest franchisors don't arise from good franchisees; they come from dishonest or incompetent franchisees. If a franchisor grants an exclusive franchise for all of California to one franchisee and that franchisee does not exploit his opportunity and produces little or no sales, is that good cause for terminating the franchise? If it is not, in whose interest is continuing that franchise, the franchisor's or the franchisee's? If a franchisee prefers to advertise his franchise services to a population of 14 million people only by word of mouth and he generates $273.00 in volume annually by doing so, is that good cause for terminating a franchise? If a franchisee operates a franchise in some manner which damages the goodwill of the franchisor, is that good cause for terminating a franchise?

I not only don't have all the answers, I don't even have any of the answers, but I hope my comments will result in any proposed legislation being considered from the franchisor's perspective in addition to the franchisee's perspective.

According to the report I received, in 1988 there were 416,878 franchise businesses operating in the United States employing an estimated 7 million workers. Franchising is important and franchisors are not the only ones who can earn incomes by offering worthwhile products or services. When properly executed, franchising provides significant returns to everyone involved. Don't adopt legislation which could needlessly strangle the industry!

Thank you in advance for your consideration of the above comments.

Very truly yours,

Robert E. Mulloy, Jr.

Robert E. Mulloy, Jr.
Attorney at Law

REM/dc

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Reply to: Edmonton

April 6, 1990

File No.: H/00043

H & R Block, Inc.
Corporate Headquarters
4410 Main Street
Kansas City, Missouri
64111

Attention: Robert E. Mulloy, Jr.

Dear Sirs:

Re: H & R Block Canada, Inc.
Application for Statutory Exemption Under the Alberta Franchises Act

We acknowledge receipt of the above referenced application on April 5, 1990. The goal of the Alberta Securities Commission Agency (the "Agency") is to review and analyze the material contained in the application and issue our initial deficiencies within twenty (20) business days from the date the application was received. If you do not receive our initial deficiency letter by May 1, 1990, please contact the undersigned.

This letter is only an acknowledgement that the application has been received. The application and related materials have not yet been reviewed and the issuance of this letter does not mean that the completeness or acceptability of the application has been determined. Only after all deficiencies have been acknowledged as resolved, will this determination be made. If it is then determined that the application is acceptable, we will invite you to file final materials with us for the purpose of obtaining a formal receipt/acknowledgement of exemption on the application.

You are reminded that there can be no trading in franchises in the Province of Alberta until such time as a formal receipt/acknowledgement of exemption has been issued by the Agency, but any current registration or exemption is still valid until its expiry date.

Enclosed is our receipt no. 54692 for payment of $300.00 filing fee.

Yours truly,

M. Kroetsch

R.J. Turner, C.A.
Director, Franchises

/mk

Enclosure

QUESTIONS SUBMITTED BY HON. SILVIO O. CONTE TO HEARING WITNESSES

QUESTIONS FOR NEAL SIMON

HOW DO YOU EXPLAIN THOSE INCREDIBLY LENGTHY AGREEMENTS MR. BARKOFF SPOKE OF ? DO YOU THINK THE AVERAGE INVESTOR OR FOR THAT MATTER THE AVERAGE LAWYER CAN UNDERSTAND THAT KIND OF A DOCUMENT ?

YOU STATED IN YOUR WRITTEN TESTIMONY THAT A FRANCHISEE HAS CHOICES, AND THE FRANCHISEES DON'T HAVE TO TAKE THE AGREEMENTS, YET YOU ALSO CLAIM THE FRANCHISES ARE UNIQUE, HOW DOES THE AVERAGE PERSON DEAL WITH THAT KIND OF A CHOICE AND SITUATION SAFELY ?

YOU SAID THAT 12 STATES REQUIRE SPECIFIC LANGUAGE TO FILE, IF YOU WANTED TO FILE IN ALL 14 STATES REQUIRING DISCLOSURE STATEMENTS HOW MANY DIFFERENT WAYS WOULD YOU NEED TO FILL OUT A U.F.O.C. FORM ?

MR SIMON, WHY DOES YOUR ORGANIZATION OPPOSE ADOPTION OF THE NCCUSL UNIFORM ACT ?

RESONSES OF NEIL SIMON TO
QUESTIONS SUBMITTED BY HON. SILVIO O. CONTE
HEARING ON FRANCHISING IN THE U.S. ECONOMY

The economy in the northeast, particularly in Massachusetts, is in a near recession. Do you agree with Ms. Bollinger that this creates a climate for fraud?

RESPONSE: It is axiomatic that the climate for fraud exists anytime potential investors begin to ignore fundamentals of sound business judgement. To the extent that a recessionary economy places a larger portion of the population in a position that requires consideration of new financial options, it is understandable how the pool of potential fraud victims may increase proportionately. However, because fraud occurs primarily as a result of the absence of accurate and complete information, the current federal requirements concerning disclosure to prospective franchisees provides a substantial overall safeguard against this sort of abuse.

I'm worried about people being taken advantage of by franchisors. Does the A.B.A. offer any help to lawyers representing prospective franchisees? Does anyone?

RESPONSE: Both the American Bar Association and the International Franchise Association hold annual two day franchising seminars which include extensive presentations and detailed workshops concerning all aspects of franchise/legal issues. These meetings are open to attorneys, franchisee representatives included. While the IFA's program is oriented primarily toward the franchisor's viewpoint, there is perhaps no better education for franchisee legal representatives than to listen to and observe the issues that concern franchisors and the solutions recommended and discussed by franchisor advocates. The ABA meeting features numerous sessions which address franchisee concerns and its planners clearly endeavor to provide an educational opportunity to attorneys representing both sides of the franchise transaction.

In addition, many of the large franchise systems now have franchisee associations which often employ their own legal counsel. These individuals are generally well versed in franchisee rights and willing to share their knowledge and experience with other legal representatives of franchisees.

There seems to be some disagreement over the ability of common law contract actions to resolve franchise agreement disputes, could you clarify? Wouldn't a contract entered into by a party who was completely at a disadvantage be void for public policy reasons? What is the best defense in the absence of state or federal regulation?

RESPONSE: Some commentators have expressed the concern that principles of common law of contracts (eg. fraud, duty of good faith and fair dealing) are inapplicable to franchise agreements as a class of commercial arrangements. There is wide disagreement on this point and well reasoned cases can be found which both support and reject this premise.

Common law principles are best utilized when a contract must be construed or judged in the absence of the clear written intent of the parties. In large part, as a response to the claim that franchisors take advantage of unsophisticated franchise investors, most franchisors endeavor to spell out in great detail the rights, duties and obligations of parties to the franchise agreement. When such a contract is illuminated by the required disclosure document, this process makes franchise purchasers among the best informed of all business purchasers and is one of the best methods for reducing fraud in the sales process.

Whether or not a contract which puts one party at a complete disadvantage would be void for public policy reasons is greatly dependent on the facts of any situation and not easily subject to generalizations. The precise nature of the "disadvantage," the method by which it was incurred and the consideration received in exchange are all necessary pieces of information in formulating a meaningful answer. It is clear however, that declaring any commercial contract void on public policy grounds is a broadsweeping remedy which involves many assumptions about the fundamental values in our society and, as such, is likely to be approached with extreme caution by all representatives of the judiciary.

The best defense in the absence of state or federal regulation, as alluded to above, is the existence of general principles of common law which cover contracts and fraud. These common law principles are by no means arcane as they provide a substantial level of protection on which many parties to commercial relationships currently rely. They are being developed literally on a daily basis as new cases are decided and therefore provide an ever growing body of fundamental guidelines for conduct of parties to contractual relationships.

4. QUESTION: How do you explain those incredibly lengthy agreements Mr. Barkoff spoke of? Do you think the average investor, or for that matter, the average lawyer, can understand that kind of document?

RESPONSE: The length of the franchise agreement does not necessarily indicate how advantageous or disadvantageous it may be for an investor. IFA certainly supports the use by franchisors of concise and easily understood contracts, but to judge the fairness or clarity of a franchise agreement based solely on its number of pages is to misapprehend several fundamental facts about franchising as a method of distribution.

The franchise contract is the written embodiment of a complex method of business operation. The average franchise contract spells out the parties' rights and obligations in numerous and diverse areas which include real estate acquisition, finance, equipment and operating standards, intellectual property licensing, transfer or sale of the franchise, rights of the parties to terminate the relationship and the obligations which subsequently arise, and dispute settlement. Further, since it is in the nature of a franchise system to mature and change over time, many contracts may also provide mechanisms for developing, suggesting or implementing changes in any one of these areas. To attempt to treat such complex matters in fewer words than is required to define clearly both parties' rights is in neither party's best interest. In fact, as the individual franchisee's reliance on the franchisor as its source of business expertise is an important factor in the success of the venture, it is far more beneficial for a franchisee that the contract describe his rights and obligations in as much detail as possible.

However, in response to the concern that franchise contracts by their very nature are complex documents, 14 states and the Federal Trade Commission have enacted laws which require the delivery of an "offering circular" to a prospective franchisee prior to consummating a franchise sale. This document, which must include a copy of the actual franchise agreement, contains information about the franchisor and the franchise system and describes, in plain language, all substantive provisions of the franchise agreement.

By utilizing this document, the prospective franchisee or its advisor can compare the actual contract language with the plain language description, and obtain a clear understanding of the meaning and intent of all material provisions of the franchise agreement.

5. QUESTION: You stated in your written testimony that a franchisee has choices and that the franchisee doesn't have to take the agreement, yet you also claim that franchises are unique. How does the average person deal with that kind of a choice and situation safely?

RESPONSE: One of the great strengths of our free enterprise system is the freedom of choice offered to the American investor. Indeed, dealing with a choice between competing products when making an investment decision comes as second nature to the average U.S. consumer. Most Americans would likely find the absence of choice far more difficult to comprehend and accept.

Today, there are over 2,200 different business format franchise concepts operating in 60 different industries. A prospective purchaser may choose from among several viable alternatives in nearly any industry segment where franchising is used. It is precisely this freedom of choice, which the franchise distribution method is uniquely able to provide, which ensures a measure of safety not available to entrepreneurs entering business through other means.

Because a prospective purchaser is able to compare and contrast franchise selections, each of which may be within a range of acceptability, the purchaser is assured of making the most informed or "safe" decision.

Another factor that must be considered is the rationale for a franchisor using a standard form of franchise agreement. The concept of uniformity is at the very heart of any successful franchise system, for it is just this uniformity, i.e. consumer recognition, which a franchisee purchases. To vary each agreement at the purchaser's request would be to destroy the concept which attracted the purchaser to the franchise system. It could also impose transaction costs unacceptable in many systems.

When all of these facts are considered, it becomes clear that franchise purchasers benefit immensely from system uniformity. Further, approaching a franchise purchase by evaluating several competing alternatives is not at all unusual and, in fact, forces many purchasers to closely scrutinize the alternatives, resulting in a far better informed purchase decision than might have otherwise been made.

6. QUESTION: You stated that 12 states require specific language to file. If you wanted to file in all 14 states requiring disclosure statements, how many different ways would you need to fill out the UFOC form?

RESPONSE: Registration of a franchise in the two additional states, which presumably would not require the inclusion of state specific language within the UFOC, could be accomplished with one uniform disclosure statement. In this example, if a franchisor already had 12 different disclosure statements filed with 12 different states, a 13th uniform disclosure statement would be required for the other two states, since each of the other 12 disclosure statements would contain language unique to the state in which each was filed.

It has long been IFA's position that such non-uniformity among state law requirements provides minimal, if any, additional protection to purchasers, while placing costly, and sometimes prohibitive, compliance burdens on franchise companies.

7. QUESTION: Mr. Simon, why does your organization oppose adoption of the NCCUSL Uniform Act?

RESPONSE: As the representative of a highly and irrationally regulated group of businesses, IFA has repeatedly called upon state and federal regulators to develop an alternative to the current morass of state franchise laws which place unwieldy compliance burdens on franchisors while conferring questionable benefits on franchise purchasers.

To date, the only tangible response has been the promulgation of the NCCUSL and NASAA so-called "uniform" or "model" laws. These acts, which are unlikely to be adopted uniformly in any state, hold the potential of creating yet another layer of regulation. IFA's position has been and continues to be that what is needed is not more laws, but the coordination of those laws which already exist. IFA recognizes the need for regulation of franchise sales and the benefits this brings to both franchisors and franchisees. However, unless the Uniform Act and any other such model laws actually address the lack of uniformity in the current system, their potential to exacerbate an already unmanageable problem far outweighs their usefulness.

QUESTIONS FOR DEBRA BOLLINGER

MS. BOLLINGER, I NOTE THAT ONLY 15 STATES HAVE FRANCHISE LAWS, IF THEY ARE SO NECESSARY WHY HAVEN'T MORE BEEN ADOPTED ?

IN YOUR TESTIMONY YOU SEEM TO SUPPORT A MINIMUM FEDERAL STANDARD WITH STATE LAWS THAT EQUAL OR SURPASS IT, THEN WHY DO YOU FEEL THE FTC NEEDS MORE FUNDS ? ARE YOU SUGGESTING STATE OVERSIGHT OR FEDERAL OR BOTH ?

DO YOU THINK A UNIFORM FEDERAL SCHEME IS A GOOD IDEA OR WOULD YOU LIKE TO SEE A CONTINUATION OF CURRENT SYSTEM WITH BROADER USE OF STATE LAWS ? WHY WOULD A FEDERAL UNIFORM RULE BE GOOD OR BAD?

RESONSES OF DEBRA BOLLINGER TO QUESTIONS SUBMITTED BY HON. SILVIO O. CONTE HEARING ON FRANCHISING IN THE U.S. ECONOMY

1. *I note that only 15 states have franchise laws. If they are so necessary, why haven't more been adopted?*

While it is true that only 15 states[1] have adopted franchise laws, these states police in excess of **40 percent** of all franchising activity nationwide. Data from the federal Census Bureau and Department of Commerce shows that there is a direct correlation between the population of a state and the level of franchising activity that takes place within its borders. Because ten of the top twenty population states regulate the sale of franchises,[2] nearly half of this nation's franchising activity undergoes scrutiny at the state level.

Pre-sale review of offering documents by franchise regulation states has the effect of raising the disclosure standard generally in the franchise market, not just in those states where the review is conducted. As Wayne Klein, bureau chief of the Idaho Department of Finance's Securities Bureau, pointed out in an April 1989 letter to the Federal Trade Commission (FTC)[3]:

"Even though not all states require registration, those that do not require registration benefit from the efforts of those that do. Few franchisors are going to sell in non-registration states only. The documents which Idaho citizens receive [in the offer or sale of a franchise] have likely been reviewed by a state requiring registration. The documents that are now being distributed are of higher quality because of that review process ..."

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[1] The 15 franchise regulation states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

[2] California, New York, Illinois, Michigan, North Carolina, Indiana, Virginia, Wisconsin, Maryland and Washington.

[3] See, letter of Wayne Klein, Bureau Chief, Idaho Securities Bureau, to Donald Clark, Secretary, Federal Trade Commission, Re: Comment of Advance Notice of Proposed Rulemaking -- Franchise Rule FTC File No. 511003, April 24, 1989.

Finally, and perhaps most importantly, states now have available a blueprint for legislative action in the form of the Model Franchise Investment Act, adopted August 30, 1990 by the membership of the North American Securities Administrators Association (NASAA)[4]. Key provisions of the Model Act include:

- A definition covering franchising;
- Registration requirements, including use of the Uniform Franchise Offering Circular (UFOC) as the disclosure document;
- Exemptions from registration for certain franchisors, but not from the anti-fraud and disclosure delivery requirements;
- Provisions covering the scope and applicability of state law;
- Deceptive and prohibited practices;
- Administrative enforcement provisions;
- Injunctive and criminal prosecution provisions;
- Private civil actions; and
- Provisions allowing for cooperation with other agencies and organizations.

It is now expected that the Model Franchise Investment Act will be introduced during the 1991 session in at least **one-half dozen** state legislatures. Several additional states now are looking at the Model Act in anticipation of introducing the act in the 1992 state legislative session.

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[4] In the U.S., NASAA is the national voice of the 50 state agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

2. *In your testimony you seem to support a minimum federal standard with state laws that equal or surpass it. If so, why then do you feel the FTC [Federal Trade Commission] needs more funds? Are you suggesting state oversight or federal or both?*

There is considerable evidence that, under its current budgetary constraints, the Federal Trade Commission (FTC) is not able to carry out even minimal enforcement or regulatory functions in connection with its Franchise Rule. The discussion of federal resources devoted to franchise regulation included in my September 27, 1990, written testimony before the House Small Business Committee, was intended to illustrate the fact that the federal government alone -- contrary to what some observers have suggested -- cannot adequately regulate the franchise marketplace. The state role in overseeing the burgeoning franchise marketplace is critical to the continued protection of consumers from fraudulent and abusive franchise promoters.

Certainly, NASAA believes that there is a role for both the federal and state governments in the regulation of franchise activity. However, there must be an explicit recognition that both levels of government are critical to the continued protection of consumers from fraud and abuse in the franchising arena. The state-federal scheme now in place is aimed primarily at ensuring that prospective franchisees are provided with adequate and meaningful information with which to make their investment decisions, and in some instances, to ensure the financial viability of the franchisors.

The FTC can serve as an effective partner with the states in the regulation of franchising activity, primarily in those cases where nationwide enforcement action is needed. That activity, however, is certainly no substitute for the comprehensive state-level program of prevention, detection and prosecution.

3. *Do you think a uniform federal scheme is a good idea or would you like to see a continuation of the current system with broader use of state laws? Why would a federal uniform rule be good or bad?*

State franchise regulation is an outgrowth of the legitimate state interest in protecting citizens from fraud and abuse in the marketplace. The system of franchise regulation now in place at the grassroots level is more comprehensive than that employed by the federal government and provides safeguards to consumers not currently available under the federal Franchise Rule. Oversight of franchising at the state level is based on a recognition that a regulatory program must include the three key elements of prevention, detection and prosecution.

In fact, NASAA members would argue that a coordinated, nationwide standard already exists under state regulation. Compliance with state regulatory requirements generally is satisfied by filing the Uniform Offering Circular (UFOC) and other relevant documents with the appropriate state agency. The UFOC, a disclosure document adopted by the states in 1975 in a move toward greater uniformity, is accepted in all the states that require the registration of franchises. While there may be minor differences in individual state requirements, they are handled simply and easily by use of a state specific addendum page. In recognition of the leading role played by the states in franchise regulation, the FTC authorizes franchisors to comply with federal disclosure requirements by using disclosures either in the format prescribed by the Franchise Rule itself or the UFOC. As a result, franchisors doing business on a nationwide basis typically prepare their disclosure documents using the state-developed UFOC format, while the FTC's Franchise Rule disclosure format remains almost entirely ignored and unused.

State and federal disclosure and registration requirements have substantially improved the general structuring of franchise offerings and have enhanced investor confidence in franchise opportunities. The explosive growth in the franchising community is evidence that demonstrably fair and honest franchisors have been successful under the existing system of franchise regulation. It is the consumer who will lose if existing regulations are dismantled in the name of some vague and ill-conceived notion of a "federal uniform standard."

QUESTIONS FOR ALEX KONIGSBERG

MR. KONIGSBERG, HOW DOES CANADA REGULATE FRANCHISING ?

WHAT CHANGES DO YOU SEE IN AMERICAN OPPORTUNITIES FOR FRANCHISING IN EUROPE AFTER 1992 ?

DO AMERICAN FRANCHISORS FACE DIFFICULTIES IN DOING BUSINESS IN JAPAN ? I UNDERSTAND FROM THE COMMITTEE REPORT THAT THEY FACE DELAYS THAT SOMETIMES LAST YEARS ?

RESONSES OF ALEXANDER KONIGSBERG TO QUESTIONS SUBMITTED BY HON. SILVIO O. CONTE HEARING ON FRANCHISING IN THE U.S. ECONOMY

(1) How does Canada regulate franchising?

Other than the Province of Alberta, there are no laws, whether Federal or Provincial, which specifically regulates franchising. Rather, the franchise agreement is treated as a commercial contract and thus, subject to the laws generally applicable to commercial contracts in general.

With regard to the Province of Alberta, the Franchise Act (Alberta) contains provisions requiring both registration and disclosure in the form of a prospectus, by franchisors prior to any offer to sell or sale of a franchise unless an exemption from the provisions of the Act is available to the franchisor. There are two (2) categories of exemptions from the registration requirements of the Act, neither of which, however, is automatic. Franchisors with a net worth of $5,000,000 (Canadian funds) and with at least five (5) years of carrying-on the franchise business or having had at least twenty-five (25) franchisees carrying-on such business, will have a statutory exemption under the Act.

This exemption relates to registration only, but still requires disclosure, to a somewhat lesser degree, by way of a statement of material facts.

For those franchisors proposing one or a limited number of trades in Alberta, there is also a discretionary exemption under the Act. This exempts the franchisor from registration and in the discretion of the Chief of Securities Administration of the Agency, could also, depending on the circumstances, exempt the franchisor from the disclosure requirements. This exemption mostly relates to territorial grant involving the grant of a development or master franchise agreement in Alberta.

It is interesting to note that the Act provides an accommodation for United States franchisors by permitting them to use their standard Uniform Franchising Offering Circular as the basis for an Alberta prospectus. Such accommodation is conditional on certain revisions being made to the UFOC, including, amongst others, the addition of an Alberta face page, a statement of the Alberta statutory rights of withdrawal and recision, a statement of the applicable currency under the franchise agreement together with the current rate of exchange into Canadian dollars and any additional information or changes to the UFOC which is required in order to comply with the standards of disclosure for the prospectus under the Act. Similarly, if a U.S. franchisor is required to submit a Statement of Material Facts, his UFOC can form the basis for the statement of Material Facts, with revisions of the type discussed above.

(2) What are the opportunities for American franchisors wishing to franchise in Europe after 1992?

With the coming into effect of the single European market as envisaged by the Single European Act and Final Act, there will obviously be psychological incentives for American franchisors to expand their franchise system into the European community. These incentives will mostly be psychological in nature in that franchisors will be able to look forward to doing business in a number of countries which make up the European community in which most of the laws will have been harmonized, borders removed and import duties largely eliminated. However, and what is vitally important for franchisors, is the fact that each individual country will continue to have their own methods and ways of carrying-on business and each country will retain their own culture, identity, customs, tastes, habits, commercial usages and practices, all of which are of vital importance for the franchisor. Thus, the impact of Europe 1992 will not, in most cases, permit American franchisors to ignore the fact that they are still dealing with different countries, notwithstanding the removal of barriers, etc. I would therefore suggest that the effect of Europe 1992 for U.S. franchisors will be largely psychological and will not from a practical point of view, prove to be overly significant.

(3) Do American franchisors face difficulties in doing business in Japan?

To the best of my knowledge, I do not believe that American franchisors are treated differently from any other foreign franchisor wishing to do business in Japan. Although there is no specific legislation governing franchising as such, there are specific statutes in Japan that will impact on the grant of a franchise by a foreign franchisor to a franchisee carrying-on business in Japan.

To the extent that the foreign franchisor enters into a master franchise agreement with a sub-franchisor in Japan, the master franchise agreement must comply with the notification requirements under the Foreign Exchange and Foreign Trade Control Law. There is a thirty (30) day waiting period beginning from the date of submission of the notification of the master franchise agreement. However, such waiting period may in certain cases and depending on certain factors be reduced to two (2) weeks or even completely dispensed with. During the waiting period, an investigation of the nature of the franchise business may be carried out if it is believed that any one of four (4) criteria designated by the Foreign Exchange and Foreign Trade Control Law may be affected. The four (4) criteria, however, are of a nature that they generally have no application to master franchise agreements. In the unlikely event that one of the four (4) criteria is present, the Minister of Finance may recommend to the foreign franchisor to change the terms of the proposed agreement. In addition, a copy of the master franchise agreement must be filed with the Fair Trade Commission which reviews it with respect to its compliance with various anti-monopoly laws. Such filing must be made within thirty (30) days following execution of the master franchise agreement. Again, most master franchise agreements typically used in America will have no problem complying with Japanese anti-monopoly laws.

QUESTIONS FOR ROBERT PURVIN

THE ECONOMY IN THE NORTHEAST, PARTICULARLY IN MASSACHUSETTS, IS IN A NEAR RECESSION. DO YOU AGREE WITH MS. BOLLINGER THAT THIS CREATES A CLIMATE FOR FRAUD ?

I'M WORRIED ABOUT PEOPLE BEING TAKEN ADVANTAGE OF BY FRANCHISORS, DOES THE ABA OFFER ANY HELP TO LAWYERS REPRESENTING PROSPECTIVE FRANCHISEES ?

THERE SEEMS TO BE SOME DISAGREEMENT OVER THE ABILITY OF COMMON LAW CONTRACT ACTIONS TO RESOLVE FRANCHISE AGREEMENT DISPUTES, COULD YOU CLARIFY ?

WOULDN'T A CONTRACT ENTERED INTO BY A PARTY WHO WAS COMPLETELY AT A DISADVANTAGE BE VOID FOR PUBLIC POLICY REASONS ?

WHAT IS THE BEST DEFENSE IN THE ABSENCE OF STATE OR FEDERAL REGULATIONS ?

RESONSES OF ROBERT PURVIN TO QUESTIONS SUBMITTED BY HON. SILVIO O. CONTE HEARING ON FRANCHISING IN THE U.S. ECONOMY

1. The economy in the northeast, particularly in Massachusetts, is in a near recession. Do you agree with Ms. Bollinger that this creates a climate for fraud?

I cannot speak with authority to this question. However, as middle managers and others are laid off from their work, many, if they have the financial resources, may opt to start their own businesses instead of finding new jobs. Many will be lured by the "promise" of the reduced risks of franchising. However, because the promise of franchising is based upon very suspect statistics, and substantially inadequate disclosure, many of these people will buy into devastating investments. Worse than fraud committed by unscrupulous promoters, franchising "fraud" is perpetuated by a fundamental imbalance in the reporting standards as they currently exist.

2. I'm worried about people being taken advantage of by franchisors, does the ABA offer any help to lawyers representing prospective franchisees?

The answer is an unqualified no. The ABA Forum Committee on Franchising is made up substantially of attorneys representing, or seeking to represent franchisors. There are only a handful of franchisee attorneys, the notable of whom, Mr. Timothy Fine, passed away in the past year of cancer. There is no major association to counterbalance the substantial efficiency and power of the International Franchise Association, which is the only body that speaks for franchising currently. The IFA does offer programs, advice and counseling for prospective franchisees, but this is somewhat akin to a wolf in sheep's clothing. The primary concern of my remarks before your committee, is trying to create certain incentives to encourage franchisees to mobilize franchisee associations and self-interest groups, to provide a competitive balance to the interests of franchisees.

3. There seems to be some disagreement over the ability of common law contract actions to resolve franchise agreement disputes, could you clarify?

Franchisee disputes seldom involve breach of contract actions. Agreements are usually very one sided, and rarely does a franchisee have cause of action for breach. When a breach of contract does exist, the franchisee may have contractual actions, but is usually required to litigate the contract in the franchisor's forum state which can be many thousands of miles away.

Choice of law and forum selection clauses in franchise agreements probably constitute the largest single inequity existing in franchise agreements today.

Moreover, most franchisee disputes relate to 1) the failure of a franchisor to support the franchise; 2) the attempt of the franchisor to take over the franchise, or 3) the franchisor acting to prevent the franchisee from staying in business once the franchisee has left the franchise system.

Given the adhesive nature of franchise agreements, franchise attorneys have attempted to establish a fiduciary relationship and fiduciary duties owing from a franchisor to a franchisee. The courts have uniformly rejected this theory. The courts have stated there is a "community of interest" between franchisor and franchisee, but the courts have failed to set forth any duties one owes to the other. It is my opinion that the courts or Congress should define this "community of interest" and to find the mutual obligations and duties owed by franchisor to franchisee and vice versa. Civil remedies should be available to injured parties for the breach of the duties thus established.

4. Wouldn't a contract entered into by a party who was completely at a disadvantage be void for public policy reasons?

One-sided contracts which are imposed by one party with superior bargaining power over another party are termed "contracts of adhesion", and they are enforceable only to the extent that the courts deem them to be fair and reasonable. Franchise agreements tend to be objectionable for what they do not promise, rather than what they do.

5. What is the best defense in the absence of state or federal regulation?

Facilitating the association of franchisees to provide competitive balance in the industry is a more practical and satisfactory solution to the ills of franchising than federal or state regulation. When a "Franchisee Association" is in the position of accrediting franchisors who agreed to adhere to a fairness code of ethics, franchisors probably would scramble over one another to be accredited--to earn the so-called "good franchising seal of approval". Once franchisees are able to achieve a competitive balance of this nature, we will see equilibrium return to the industry. In the meantime, establishing the respective duties arising from the franchise relationship, and giving franchisees private rights of action to enforce those duties, and allowing them to fight any legal battles at home and under the protection of their own local laws are the best bets to protecting franchisees in the short term.

QUESTIONS FOR RUPERT BARKOFF

MR. BARKOFF IF THERE WAS A FEDERAL MINIMUM STANDARD WITH STATE LAWS PREEMPTING OR EQUALING IT WOULD YOU FORESEE ANY PROBLEMS, INCONSISTENCIES ?

THERE SEEMS TO BE SOME DISAGREEMENT CONCERNING THE EFFECT OF COMMON LAW CONTRACT SUITS ON FRANCHISE AGREEMENTS, COULD YOU CLARIFY ? WOULDN'T A CONTRACT ENTERED INTO BY A PARTY WHO WAS COMPLETELY AT A DISADVANTAGE BE VOID FOR PUBLIC POLICY REASONS ?

RESONSES OF RUPERT BARKOFF TO QUESTIONS SUBMITTED BY HON. SILVIO O. CONTE HEARING ON FRANCHISING IN THE U.S. ECONOMY

1. **Question**: The economy in the Northeast, particularly in Massachusetts, is in a near recession. Do you agree with Ms. Bollinger that this creates a climate for fraud?

   Response: I have no empirical evidence one way or the other. However, I feel that many people are always vulnerable to fraud.

2. **Question**: I'm worried about people being taken advantage of by franchisors. Does the A.B.A. offer any help to lawyers representing prospective franchisees? Does anyone?

   Response: To my knowledge, there are five groups within the A.B.A. that touch upon the area of franchising. Four of these are located within Sections of the A.B.A. (the Business Section, the Section on Antitrust Law, the Patent, Trademark and Copyright Section, and the General Practice Section). With the exception of the Patent, Trademark and Copyright Law Section, there is some attention given to the question of representing franchisees in each of these Section's activities. The question of representing franchisees is probably covered in most depth, however, within the Forum on Franchising. As my written testimony indicates, the Forum is a 2,000-member organization within the A.B.A. whose principal function is to educate its members on the subject of franchising, and to study and investigate matters within its responsibilities. Each year, the Forum on Franchising has an annual program, at which some of the topics relate directly to the issue of franchisee representation. Enclosed is a copy of the brochure for this year's program, which is scheduled for later this month. Generally, of the attorneys who attend this program, the great majority (perhaps 80% or more) primarily represent franchisees. As noted at Footnote 54 and in the accompanying text of my written testimony, it is quite difficult for attorneys to make a viable income representing exclusively franchisees.

   The A.B.A. also tries to refer franchisees who have problems to attorneys who have expressed interest in this field. During my tenure as Chairman of the Forum on Franchising, I have received several phone calls from people who have been referred to my office by the A.B.A. for further referrals to qualified franchise experts. Many of these phone calls result from recommendations by staff members at the Federal Trade Commission that the aggrieved franchisee contact the

A.B.A. for names of attorneys who have expressed proficiency in this field.

3. **Question**: There seems to be some disagreement over the ability of common law contract actions to resolve franchise agreement disputes. Could you clarify? Wouldn't a contract entered into by a party who is completely at a disadvantage be void for public policy reasons? What is the best defense in the absence of state or federal regulation?

Response: As my written testimony indicates, courts hold a high reverence for the principle of freedom of contract. This attitude is not surprising or even unwarranted. It is important to business persons that a significant degree of certainty exist in the commercial arena. Otherwise, it is extremely difficult to plan and operate business activities.

In my experience, however, it is quite evident that franchise agreements almost always substantially favor the franchisor. Therefore, if the contract covers the dispute in question, it is most likely that the contract will be interpreted in favor of the franchisor. When the contract is not so specific, ~~the re~~sults are less predictable.

If the franchisee was completely at a disadvantage when entering into the contract, the court could declare the contract void for public policy reasons or, alternatively, invoke the concept of "unconscionability." Courts, however, are highly reluctant to invoke these doctrines. Generally, they view franchisees not as helpless individuals, but as business persons, even though perhaps not that experienced in commercial affairs.

Absent state or federal regulation, there are only really two "defenses" available to a franchisee. The first is simply don't buy the franchise in the first place! Although the decision whether or not to buy a franchise is a business decision, I have on several occasions in my practice strongly suggested that the prospective franchisee decline the opportunity. This is particularly true when a franchisee might be overextending himself (e.g., taking out an equity loan on his home) and the franchise concept is in its incipient or untested stages. The other "defense" is to do as much investigation as possible about the franchisor and his franchise. This is often difficult to accomplish for several reasons. First, given the "conventional wisdom" that earnings claims only lead to lawsuits, franchisors are reluctant to make earnings claims, even with the recent liberalization of the applicable federal and state regulations. Second, it is sometimes difficult to get honest answers from existing or terminated franchisees. In the case of terminated franchisees, sometimes the franchisors have required them to sign non-disclosure agreements covering the terms of the termination. As for existing franchisees, they have a vested interest in staying on the franchisor's good side, as well as in seeing the system expand. Therefore, negative comments by them can often be self-destructive.

4. **Question**: If there was a federal minimum standard with state laws preempting or equalling it, would there be any problems or inconsistencies?

Response: In order to answer this question, I would like to distinguish the areas of franchise sales regulation from the area of franchise relationship regulation.

In the franchise sales area, we currently have a federal minimum standard for disclosure. As my written testimony indicates, this dual system of regulation does create some inconsistencies and problems, but generally they are curable, with the cost of regulation being time and money to the franchisors. My own view is that the current system works, but could work more effectively, especially if the problem of multiple franchise offering document review were eliminated.

In the area of franchise relationship regulation, a federal preemptive standard would probably not create that many inconsistencies that would be intolerable. From the franchisees' perspective, I would urge the Committee to be cautious in taking any approach in this field other than a minimum standard. That is, I would not favor total preemption. This occurred in the petroleum industry, with the result being that franchisees in many states appeared to have lost protection as a result of the federal preemptive move in this field.

From the franchisor's perspective, having to worry about many state laws, as well as a federal standard, is very burdensome and does make operation of a franchise more difficult.